THE TAXATION OF ART

DEALER * INVESTOR * OR COLLECTOR

And other current U.S. tax issues in the Art World

by

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I. TAX FREE EXCHANGED WITH WORKS OF ART

Maintaining a collection in good condition is expensive; the expenses may include framing, re-framing, lighting, air conditioning and humidity controls, cleaning and other maintenance, security devices, publications, and insurance. The collector may incur travel and other buying expenses and fees when he or she adds to a collection. Those costs have increased substantially in recent years.

This section focuses on the deductibility of the expenses of maintaining a collection, the tax treatment of gains and losses realized on sale of a collection, whether a collection can be used in a tax free exchange, certain problems of insurance, and sales tax issues. Identification as a dealer, an investor, or a collector and the tax ramifications of each are discussed.

May an art owner deduct all, some, or a portion of such collection-related expenses and losses incurred in holding the collection as an investment, or are all those expenses nondeductible personal expenses incurred in a hobby for personal use and enjoyment? Before that question can be answered, it is necessary to determine whether the individual in question is a dealer, an investor, or a collector and to examine the general statutory provisions.

A. DEFINITIONS

1. Dealer

A dealer is someone engaged in the trade or business of selling works of art, primarily to customers. Although the term "trade or business" is not specifically defined in the Internal Revenue Code, court cases indicate that it is the pursuit or occupation to which one contributes a major or substantial part of one's time for the purpose of livelihood or profit.

In December 1983, the United States Court of Appeals for the Second Circuit held that the determination of whether a taxpayer is engaged in a trade or business is not based on all the facts and circumstances. Instead, the Second Circuit ruled that the

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following three specific conditions must exist for a trade or business status to be recognized:

1. The taxpayer must be regularly engaged in the activity.
2. The activity must be undertaken with the expectation of making a profit.
3. The taxpayer must hold himself or herself out to others as engaged in the selling of goods and services.

Then, in 1987, in Commissioner v. Groetzinger, the United States Supreme Court reaffirmed a facts-and-circumstances test and rejected the Second Circuit's condition that the taxpayer must hold himself or herself out to others as engaged in the selling of goods and services. The Court stated that a judicial attempt to formulate and impose a test for all situations would be counterproductive, unhelpful, and even somewhat precarious for the overall integrity of the Internal Revenue Code.

The Court stated that, in order to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity, and the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify. Moreover, mere investment activities do not constitute a trade or business.

2. Investor

An investor is someone who buys and sells works of art primarily for investment, rather than for personal use and enjoyment or as a trade or business. The cases in the securities area that distinguish a dealer from an investor should be equally applicable to the art world. The word "primarily" means of first importance. The key is whether the taxpayer is engaged in the investment activity with the primary objective of making a profit.

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5 Comm'r v. Groetzinger, 107 S. Ct. 980 (1987). The Groetzinger case dealt with the question of whether a gambler was engaged in a "trade or business" as used in Code sections 162(a) and 62(1). The Supreme Court did limit its findings to the Code sections at issue in the case.


7 Wood v. Comm'r, 16 T.C. 213 (1951); Kemon v. Comm'r, 16 T.C. 1026 (1951); see Hollis v. United States, 121 F. Supp. 191 (N.D. Ohio 1954); Seeley v. Helvering, 77 F.2d 321 (2d Cir. 1953); Nehring v. Commissioner, 16 T.C.M. (CCH) 224 (1957); Priv. Ltr. Rul. 8140015.

8 Malat v. Riddell, 383 U.S. 569 (1968); Treas. Reg. § 1.212-l(c).
In *Thomas B. Drummond*, the taxpayer was a psychologist who devoted an average of fifty-eight hours a week to his psychology practice. During the 1970s, the taxpayer, who had an interest in and enjoyed art, purchased a number of drawings at auction or from private galleries. Having conducted research about the drawings throughout the 1970s and 1980s, he concluded that one of them (Three Famous Heads by Michelangelo Anselmi), which he had purchased for $1,300, could be sold for about $100,000. The taxpayer sold the drawings to a museum for $115,000 in 1989. He made no other sales of drawings during the 1980s and through 1994. The taxpayer reported the gain from the sale as ordinary business income on income tax form 1040, schedule C, not as long-term capital gain on schedule D, since the schedule C business income enabled him to obtain a larger deduction for a contribution to his retirement plan. The court had to decide whether the gain from the sale of the drawings was gain from property held by the taxpayer "primarily for sale to customers in the ordinary course of his trade or business" within the meaning of section 1221(a)(1). If it was, the gain at issue was ordinary income; otherwise, it was long-term capital gain. As used in section 1221(a)(1), the word "primarily" means "of first importance" or "principally." The court concluded that the taxpayer was not engaged in a trade or business with respect to his art activities and that the gain on the sale of the drawings was long-term capital gain.

The case contains an excellent summary of the relevant principles, pointing out that the purpose of section 1221(a)(1) is to differentiate between the profits and losses arising from the everyday operation of a business and the realization of appreciation in value accrued over a substantial period of time from an investment. In determining whether a transaction is primarily from the operation of a business or from investment, the courts have examined various factors, including the following: (1) the purpose for which the property was acquired; (2) the purpose for which it was held; (3) the frequency, continuity, and substantiality of sales; (4) the duration of ownership; (5) the use of the proceeds from the sale of the property; (6) the business of the taxpayer; and (7) the time and effort that the taxpayer devoted to sales activities relating to the asset in question by developing or improving that asset, soliciting customers, and advertising. No single factor or combination of factors is necessarily controlling, and objective factors carry more weight than the taxpayer's subjective statement of his or her intent.

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10 In calendar year 1989, long-term capital gains were taxed at 28 percent and ordinary income was taxed at a maximum of 33 percent. See note 118 in article 14.
11 *Drummond*, supra note 8, citing Malat v. Riddell, supra note 7. See Pasqualini v. Commissioner, 103 T.C. 1, 6 (1994).
12 *Drummond*, supra note 8 at 1967; see Graves v. Commissioner, 867 F.2d 199, 202 (4th Cir. 1989).
3. Collector

A collector is someone who buys and sells works of art primarily for personal pleasure and is neither a dealer nor an investor and, ordinarily, may not deduct expenses and losses.


The statutory framework involves the interaction of sections 67, 68, 162, 212, 165, 183, and 262 of the Internal Revenue Code of 1986, as amended.

- Section 67 generally limits miscellaneous deductions to those that exceed 2 percent of adjusted gross income.
- Section 68 generally limits an individual taxpayer's ability to claim itemized deductions if the taxpayer's adjusted gross income exceeds a specified statutory amount.
- Under section 162, a taxpayer may deduct from gross income all ordinary and necessary expenses incurred in a trade or business.
- Under section 212(1) and (2), a taxpayer may deduct expenses incurred in the production or the collection of income.
- Section 165 permits the deduction of losses sustained in a trade or business or in a transaction entered into for profit.
- Section 183 qualifies the foregoing provisions by specifically disallowing, with certain exceptions, deductions attributable to activities not engaged in for profit.
- Section 262 denies a deduction or loss for expenses that are personal in nature.

Therefore, a taxpayer claiming a deduction for an expense under section 162 or section 212 or for a loss under section 165 must be able to demonstrate an associated profit motive in order to avoid the ban of section 183 or section 262.

B. EXPENSES

1. Prior Law

Before the Tax Reform Act of 1969 added section 183 to the Internal Revenue Code, collection-related expenses were deductible only by someone who is a dealer—that is, someone engaged in a trade or business—or an investor—that is,
someone who holds the collection for the production of income.\textsuperscript{13} The Court of Claims dealt with the issue of the deductibility of collection-related expenses in the \textit{Wrightsman} case.\textsuperscript{14}

Charles Wrightsman was an art collector, not a dealer, and he conceded that he had originally purchased some works of art as a hobby and that he did derive pleasure and satisfaction from keeping his collection in his residence. However, he claimed that the property was held primarily for investment and, therefore, that the expenses related to the investment were deductible. The court disallowed the deductions, ruling that the test to be applied is whether, as a factual matter from an objective view of the operative facts and circumstances, the taxpayer acquired and held the works of art primarily for investment, rather than for personal use and enjoyment.

In \textit{Wrightsman}, the Court of Claims also established the following guidelines and criteria:

\textsuperscript{13} I.R.C. § 262; Treas. Reg. § 1.212-1(c); Rev. Rul. 68-232, 1968-1 C.B. 79.
\textsuperscript{14} Wrightsman v. United States, 428 F.2d 1316 (Ct. Cl. 1970).
1. The collector must establish that the investment purpose for acquiring and holding the items in the collection was "principal" or "of first importance."\(^15\)

2. Artworks or other items that make up a collection can be the subject matter of investment. (A number of investment funds have been started with the intention of investing only in artworks, including Sovereign American Arts, Collectors Funding, Art Fund, and Fine Arts Fund.)\(^16\)

3. The collector must intend to hold the property for investment. That intent can be shown by an analysis of the art collector's financial position, the collector's investment history, whether the collector believes that works of art are a hedge against inflation, and whether the collector has made personal declarations of investment purpose and intention that are supported by circumstances and conduct evidencing that intention. Other indications of investment intent include the following:
   a. Consulting with experts on purchases
   b. Reading pertinent publications
   c. Participating in collection-related activities
   d. Devoting time to the collection
   e. Making an effort to display the collection publicly, so as to enhance its value
   f. Developing expertise about the collection
   g. Keeping businesslike records and using a businesslike method of accounting for the collection\(^17\)

4. The retention of a collection, without any profitable sales, is not a bar to a showing that the property is held for investment.\(^18\)

\(^{15}\) See Malat, supra note 7; Treas. Reg. \$ 1.212-1(c).

\(^{16}\) Shorting Rembrandt, FORBES, Mar. 15, 1970, at 78; see Note, Why Think Of Your Estate As A Collection?, 117 Tr. & Est. 662 (1978).

\(^{17}\) Tatt v. Comm'r, 166 F.2d 697 (5th Cir. 1948).

5. Even though the collector uses part of the collection to fulfill personal needs, that use does not make the collector's overall activity a hobby.

6. The fact that pleasure is derived from investment property does not preclude deductions.\textsuperscript{19}

7. The fact that there is no substantial relationship between the collector's principal occupation and his or her collection activities is of little significance.

8. The proportion of the collection-related expenses that is attributable to the personal use of the collection is not deductible. The proportion attributable to personal use is a close approximation based on all the facts and circumstances.\textsuperscript{20}

On the basis of the facts presented in \textit{Wrightsman}, the report of the trial commissioner of the Court of Claims recommended that the deduction for the art-related expenses be allowed.\textsuperscript{21} A dissenting opinion to the decision of the full court adopted the conclusion of the trial commissioner and, we believe, should have been the conclusion reached by the court.

\textbf{2. Conclusions under Wrightsman}

Under section 162, the dealer who buys and sells works of art can deduct the ordinary and necessary business expenses incurred in the trade or business of being a dealer.

Under section 212(1) or section 212(2), the investor who buys and holds works of art primarily for investment can deduct the ordinary and necessary expenses incurred in connection with property held for the production of income.

Under section 262, the collector cannot deduct art-related expenses in connection with collecting activities, since those expenses are nondeductible personal expenses.

Still, the opinion in \textit{Wrightsman} indicates that the collector faces an extremely difficult, although not impossible, task to prove that he or she is an investor. In the past not many collectors were able to show that they acquired and held the works of art primarily for investment, rather than for personal use and enjoyment. Currently, with ever increasing prices for top quality works of art, the drop in interest rates and the

\textsuperscript{19} Tyler v. Commissioner, 6 T.C.M. (CCH) 275 (1947); Demler v. Commissioner, 25 T.C.M. (CCH) 620 (1966).

\textsuperscript{20} Cohan v. Commissioner, 39 F.2d 540 (2d Cir. 1930).

Inherent risk in the stock market, more collectors are acquiring works of art as investment property and should be able to carry the burden of proof that he or she is, in fact, an investor in works of art.22

3. **Section 183**

The Tax Reform Act of 1969 introduced section 183 to the Internal Revenue Code, effective January 1, 1970.23 Although the section is known as the hobby-loss provision, because it disallows deductions and losses from activities not engaged in for profit, it does permit the deduction of certain collection-related expenses that were not previously deductible. Section 183(a) provides the following:

In the case of an activity engaged in by an individual or an S corporation, if such activity is not engaged in for profit, no deduction attributable to such activity shall be allowed under this article except as provided in this section.

Section 183(c) defines the term "activity not engaged in for profit" to mean

any activity other than one with respect to which deductions are allowable for the taxable year under section 162 or under paragraph (1) or (2) of section 212.

Therefore, for a collector to avoid the application of section 183, a collection-related expense has to be from an activity engaged in for profit and the expense must be deductible under section 162 or section 212(1) or (2). As previously discussed, the *Wrightsman* case makes the deduction of collection-related expenses under such sections extremely difficult because of the onerous burden of proof the taxpayer has in proving to the Internal Revenue Service (IRS) that he or she incurred the expenses in connection with works of art held primarily for investment. A collector can avoid section 183 only if he or she can prove that the intent to make a profit was the main motivation for the activity. The question of a collector's intent is by its nature a subjective inquiry.

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22 See Art & Auction, August 2004, entire issue devoted to "investing in art"; N.Y. Times, July 23, 2004, section E page 2 announcing the establishment of an art investment fund that intends to raise millions of dollars for investment in works of art.

23 Lee, A Blend of Old Wines in a New Wineskin: Section 183 and Beyond, 29 TAX L. REV. 347 (1974); Burns & Groomer, Effects of Section 183 on the Business/Hobby Controversy, 58 TAXES 195 (1980); Khorsandi, Does Your Client Have a Profit Motive? An Analysis of Tax Court Criteria Used To Evaluate A Taxpayer's Profit Motive Under Section 183, 47 TAX LAW. 291 (1993); Lewicki, Home Office, Vacation Home and Home Rental Deductions, 547-2nd Tax Mgmt. Section VIII (BNA); Campbell, Hobby Activities Can Increase Tax Liability, 53 TAXATION FOR ACCOUNTANTS 78 (1994); Note, Racing Without A Profit Objective and Crashing Into Section 183: Zidar v. Comm'r, 55 Tax Lawyer 871 (2001/02).
that can be determined only by examining a variety of objective facts. As summarized by the Senate Finance Committee,

the facts and circumstances (without regard to the taxpayer's subjective intent) would have to indicate that the taxpayer entered upon the activity, or continued the activity with the objective of making a profit.

Regulation section 1.183-2 sets forth a number of factors similar to the indications of investment activity listed in *Wrightsman* to be considered in determining whether or not an activity is engaged in for profit. The factors were promulgated in an effort "to comply with the congressional purpose of establishing objective tests to determine subjective intentions." While the focus on the determination of profit motive is on the subjective intention of the taxpayer, the objective criteria set forth in Regulation section 1.183-2(b) may be cited to establish the taxpayer's true intent. Those factors are the following:

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1. The manner in which the taxpayer carries on the activity. A businesslike manner with complete and accurate books and records is more likely than not to be profit-motivated. The businesslike operation of the activity is probably the most important factor in indicating a profit motive. It is likewise important to be able to show that the taxpayer changed methods in response to a period of losses or pursuant to professional advice. In *Churchman*, the court found that an artist carried on her artistic activities in a businesslike manner for profit since her work did not stop at the creative stage but went into the marketing phase of the art business, where the recreational element is minimal. For the taxpayer with a collection, the maintenance of businesslike records is essential. A collector who maintains good books and records for his or her activity is more likely to have the profit intent required to escape section 183. This should include the purchase or sale details from an art transaction. It would be helpful in proving profit intent if prior to the purchase of a work of art the collector had a written analysis of comparable prices for similar works by the same artist and other relevant financial data. Failure to maintain adequate financial books and records may be viewed as lacking the necessary profit intent.


31 Krebs v. Comm'r, 63 T.C.M. 2413 (1992) (promotion of wife's music career conducted in businesslike manner); Peacock v. Comm'r, 83 T.C.M. (CCH) 1662 (2002) (taxpayers never studied tournament fishing from a business person's point of view); Lewis v. Comm'r, 64 T.C.M. (CCH) 269 (1992) (taxpayers engaged in sailboat charter activity did not conduct it in businesslike fashion because books and records were incomplete, boat was docked at marina that prohibited commercial use, and taxpayers bought insurance for personal use only); Sloan v. Comm'r, 55 T.C.M. (CCH) 1238 (1988), aff'd in unpub. opin. (4th Cir. 1990) (federal employee had no profit motive for his weekend legal practice where it was not conducted in a businesslike way: he billed only a few of his clients, did not keep timesheets or carry malpractice insurance); Hires v. Comm'r, 40 T.C.M. 342 (CCH) (1980) (publishing and writing activities related to the taxpayer's botanical research were not carried on in a businesslike way); Schwartz v. Comm'r, T.C.M. 2003-86; Zarins v. Comm'r, 2002-2 USTC ¶ 50,471.

2. The expertise of the taxpayer or the taxpayer's advisers. Preparation for the activity by an extensive study of accepted business, economic, and scientific practices or by consultations with experts may indicate a profit motive.\textsuperscript{33} For the taxpayer with a collection, consultation with art experts and subscriptions to auction catalogs and collection magazines indicate a profit motive. Obtaining from time to time a fair market value appraisal by an independent art appraiser for the taxpayer's collection would be indicative of a profit intent.\textsuperscript{34}

3. The time and effort expended by the taxpayer in carrying on the activity. Spending a great deal of time and effort is more likely than not to indicate a profit motive.\textsuperscript{35} Although it would be burdensome and inconvenient, a collector who kept a diary of the time devoted to visiting museums, art shows, art fairs, galleries, reading art magazines, consulting with auction houses, art dealers and art experts would have an easier time of showing a profit intent than a collector without such records.

4. The expectation that assets used in the activity may appreciate in value. The term "profit" does encompass appreciation in value of the assets, but unrealized appreciation alone may not be sufficient.\textsuperscript{36} The taxpayer must show that his or her primary purpose is ultimately to realize a gain from the appreciation in value of the asset.\textsuperscript{37} Since the mere owning of a collection produces no income, a profit can be realized only from future appreciation of the collection. But the expectation of appreciation may be insufficient in and of itself to escape the provisions of section 183.\textsuperscript{38}


\textsuperscript{34} Kretschmer v. Comm'r, 57 T.C.M. (CCH) 441 (1989); Roach v. Comm'r, 58 T.C.M. (CCH) 545 (1989); Ragghianti v. Comm'r, 55 T.C.M. (CCH) 446 (1988).


\textsuperscript{36} Treas. Reg. § 1.183-2(b)(4). Capodice v. Comm'r, 56 T.C.M. (CCH) 829 (1988) (holding property solely with expectation that it will eventually increase in value does not establish profit motive).

\textsuperscript{37} Jasienski v. Comm'r, 64 T.C.M. (CCH) 1369 (1992) (unrealized appreciation in limousines relevant in determining profit objective).

5. The success of the taxpayer in carrying on other similar or dissimilar activities for a profit. The fact that the taxpayer has engaged in similar activities in the past and converted them from unprofitable to profitable may indicate that he or she is engaged in the present activity for profit, even though the activity is presently unprofitable.39

6. The taxpayer's history of income or losses with respect to the activity. A series of realizations of income may indicate a profit motive.40 But the realization of income must be reasonable in light of the activity. For example, a collector who spent $5,000 traveling throughout Europe in pursuit of travel photography, but sold only $30 of pictures, did not have a profit motive.41

7. The amount of occasional profits, if any, that are earned. A taxpayer who generates only infrequent and small profits is not likely to have a profit motive.42 A sale of an item in a collection at a large gain is clear evidence of a profit motive.

8. The financial status of the taxpayer. The fact that the taxpayer does not have substantial income or capital from sources other than the activity in question may indicate that the activity is engaged in for profit.43 On the other hand, a taxpayer with substantial income from sources other than the activity in question may not have a profit objective, especially if personal or recreational elements are involved.44 For the collector of valuable items of property, the presence of other sources of income is a difficult element to overcome. Obviously, this is a "catch-22" provision and should be given less weight for the collector since valuable items can not be purchased by someone who does not have other sources of income and substantial liquid assets. A taxpayer's wealth, or lack thereof, should not be a major factor in determining a profit motive from a collecting activity.

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40 Treas. Reg. § 1.183-2(b)(6).
42 Treas. Reg. § 1.183-2(b)(7). Compare Dwyer v. Comm'r, 61 T.C.M. (CCH) 2187 (1991) (the large auto purses sought by the taxpayer supported his profit motive), with Plunkett v. Comm'r, 47 T.C.M. (CCH) 1439 (1984) (taxpayer could not cover his expenses even if he won every mud race he entered).
43 Treas. Reg. §1.183-2(b)(8).
44 Id.
9. Elements of personal pleasure or recreation. The regulations indicate that, the greater the pleasure, the less likely it is that the collector has a profit motive.\textsuperscript{45} Although not required by the Internal Revenue Code or \textit{Wrightsman}, a physical segregation of the art investment property from the taxpayer's personal residence or office generally helps the taxpayer prove his or her profit motive. Since a collecting activity generally has strong elements of personal pleasure, it can be expected that the IRS will cast a doubtful eye on anyone claiming that the activity is primarily profit-motivated.\textsuperscript{46} However, the regulations do indicate that a taxpayer with both profit and non-profit objectives may satisfy the profit intent requirement. The regulation states: "[T]he fact that the taxpayer derives personal pleasure from engaging in the activity is not sufficient to cause the activity to be classified as not engaged in for profit if the activity is in fact engaged in for profit as evidenced by other factors whether or not listed in this paragraph."\textsuperscript{47}

No one of the above factors is determinative, and the determination of a profit motive is not limited to the above factors. The test is this: based on all the facts and circumstances, is a profit motive present?

The main objective of section 183 is to disallow deductions attributable to an activity not engaged in for profit. The nine factors listed above present an almost insurmountable barrier for a collector. Therefore, section 183(a) is an effort by the IRS to disallow deductions for all collectors who are not dealers or investors.

\textit{i. Section 183(b)}

Section 183(b) does offer some help to the collector. The section allows the collector to claim deductions for expenses attributable to an activity not engaged in for profit up to the amount of the gross income derived from the activity, after first deducting those items, such as certain items of interest and taxes, that are allowable without regard to whether an activity is engaged in for profit.\textsuperscript{48}

As discussed above, if the taxpayer can satisfy section 212(1) or (2), the collection-related expenses are deductible whether or not the taxpayer had any gross income from collection activities since he or she is classified as an investor. If the taxpayer (as in \textit{Wrightsman}) cannot satisfy the test of section 212 (1) or (2), the taxpayer

\textsuperscript{45} Treas. Reg. § 1.183-2(b)(9).


\textsuperscript{47} Treas. Reg. 1.183-2(b)(9). However, see Treas. Reg. 1.183-2(a); Treas. Reg. 1.183-1 (d)(3) Ex. (i)

\textsuperscript{48} Treas. Reg. § 1.183-1(b)

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can claim a deduction for collection-related expenses under section 183(b) up to the amount of his or her gross income from collection activities, so long as the collector is carrying on an "activity" within the meaning of section 183 and after first subtracting such items as interest and taxes that are deductible without regard to section 183. The collection-related expenses that are then deductible under section 183(b) are subject to the 2 percent rule of section 67(a) for deductions claimed on or after January 1, 1987.\textsuperscript{49} The deductible expenses may be further limited under the provisions of section 68(a), effective January 1, 1991.\textsuperscript{50}

For example, if in \textit{Wrightsman} there had been gross income derived from the taxpayer's collection activities, the expenses at issue in that case would have been deductible under section 183(b) up to the amount of that gross income. Under prior law, if the expenses were not deductible under section 212(1) or (2), they could not be offset against any gross income from the activity not engaged in for profit.

The regulations contain detailed provisions on how to calculate the gross income from an activity for purposes of determining the amount available to offset deduction items.\textsuperscript{51} For example, the regulations require that capital gains and losses from the collection activity be merged with all other capital gains and losses of the collector from noncollection activity.\textsuperscript{52} Therefore, capital gains realized from sales of items in the collection are not available to offset collection expense deductions if the collector had losses on securities transactions that reduce the gains on collection sales to zero.\textsuperscript{53} The Taxpayer Relief Act of 1997 lowered the long-term capital gains tax on the sale of securities to 20 percent and extended the holding period to eighteen months for long-term treatment. However, for the sale of collectibles the long-term capital gains tax rate was kept at 28 percent and the holding period was kept at more than one year. The Jobs and Growth Tax Relief Reconciliation Act of 2003 (effective May 6, 2003) further reduced the long-term capital gain rate to 15 percent for sales of securities and other capital assets and reduced the long-term holding period to more than twelve months but once again maintained the 28 percent rate on gain from the sale of collectibles held for more than one year. The term "collectible gain" is defined in section 1(h)(5)(A) to mean "gain from the sale or exchange of a collectible (as defined in section 408(m) without regard to paragraph (3) thereof) which is a capital asset held for more than 1 year but only to the extent such gain is taken into account in computing taxable income." It appears as if all

\textsuperscript{49} I.R.C. § 67(a) limits the deduction for such expenses to amounts that exceed 2 percent of adjusted gross income. See Treas. Reg. § 1.67-1T(a)(1)(iv).

\textsuperscript{50} I.R.C. § 68(a). The section limits an individual taxpayer's ability to claim itemized deductions if the taxpayer's adjusted gross income exceeds a specified statutory amount. Under section 68, all otherwise allowable itemized deductions are reduced by the lessor of (i) 3 percent of the amount by which the taxpayer's adjusted gross income exceeds the statutory amount; or (ii) 80 percent of the itemized deductions.

\textsuperscript{51} Treas. Reg. § 1.183-1(b).

\textsuperscript{52} Treas. Reg. § 1.183-1(b)(4)

\textsuperscript{53} Id.
long-term capital transactions (securities and collectibles) have to be netted to see if there is any net collectibles gain before any section 183(b) deduction is allowable.

**ii. Cases under Section 183**

*Leonard L. Barcus* and *Mary L. Stanley* illustrate the difficulty that a collector has in showing that he or she was engaged in an activity for profit. In *Barcus*, the court found that a married couple who bought and sold antiques were not profit-motivated; the court recognized that the expectation of profit need not be a reasonable one but ruled that the expectation must be a bona fide one. The court noted that the antiques that were purchased were used as furnishings in the taxpayers' residence before they were sold. In holding that, on the basis of all the facts, the taxpayers' purchase and sale of antiques did not constitute a trade or business or a transaction entered into for profit, the court took into consideration the testimony of the taxpayers that the antiques might some day greatly increase in value and be sold at a large profit. The court stated:

> In reaching our conclusion we have not overlooked petitioners' statements that they owned antiques which they expected in the years to come would greatly increase in value and then could be sold at a very large profit. In our view this speculative hope of a profit at some time in the future is not persuasive that petitioners' intent in the purchase and sale of antiques was to make a profit.56

In *Stanley*, the court found that a collector of antique glass novelties and marbles had not carried the burden of proving that her collection activities were primarily for the production of income. The taxpayer in *Stanley* did not claim that she was engaged in a trade or business but only that she acquired glass novelties for investment purposes and that she published her book *A Century of Glass Toys* to enhance the marketability of

54 Barcus v. Comm'r. 32 T.C.M. (CCH) 660 (1973), aff'd per curiam 492 F.2d 1237 (2d Cir. 1974)

55 Stanley v. Comm'r, 40 T.C.M. (CCH) 516 (1980); see also Eastman v. United States, 80-2 U.S. Tax Cas. (CCH) If 9742 (Ct. Cl. 1980) (No. 538-78); Allen v. Comm'r, 72 T.C. 28 (1979); Feistman v. Comm'r, 44 T.C.M. (CCH) 30 (1982) (stamp collector showed he was profit-motivated); compare Feistman v. Comm'r, 41 T.C.M. (CCH) 1057 (1981); Dailey v. Commissioner, 44 T.C.M. (CCH) 1352 (1982); Wilson v. Commissioner, 42 T.C.M. (CCH) 787 (1981) (foot massaging activity of the taxpayer was not profit-motivated); Steele v. Commissioner, 41 T.C.M. (CCH) 1092 (1981); Burleson v. Commissioner, 46 T.C.M. (CCH) 1394 (1983) (dog breeding expenses were profit-motivated); Estate of Elizabeth Powers v. Commissioner, 84-2 U.S. Tax Cas. (CCH) f'9590 (1st Cir. June 21, 1984), aff'g 46 T.C.M. (CCH) 1333 (1983) (horse breeding expenses were not profit motivated); Salzman v. Commissioner, 55 T.C.M. (CCH) 278 (1988) (licensing of ultrasonic toothbrush was not for profit); Krivitsky v. Commissioner, 54 T.C.M. (CCH) 493 (1987) (mining activities were not conducted with a profit motive); Hawkins v. Commissioner, 54 T.C.M. (CCH) 1529 (1988) (exotic animal farm was not profit motivated); Barr v. Commissioner, 56 T.C.M. (CCH) 1255 (1989) (art publishing enterprise did. not have profit intention).

56 See Barcus, supra note 53 at 673.
her glass novelty collection. The court succinctly summarized the relevant legal principles:

The test for determining whether an activity is engaged in for profit is whether the individual engaged in the activity with the primary purpose and intention of making a profit. The taxpayer must have a bona fide expectation of realizing a profit, although such expectation need not be reasonable. Whether petitioners had the requisite intention is a question of fact to be determined on the basis of all the facts and circumstances. The burden of proof is on the petitioners, with greater weight given to objective facts than to the petitioners' mere statement of their intent. No one factor is conclusive and thus we do not reach our decision herein by merely counting the factors enumerated in section 1.183-2(b), which support each party's position.57 (citations omitted)

The court observed that there was no doubt that the taxpayer hoped or expected that her glass novelties would appreciate in value over time. However, a potential for appreciation is inherent in many, if not most, of the items that have traditionally been collected as a hobby — stamps, coins, works of art — for the pleasure afforded by the acquisition and possession of the collection itself. The mere fact that a collector is aware that the value of his or her collection may increase does not mean that he or she is primarily motivated by an expectation of profit, rather than by the personal satisfaction derived from pursuing a hobby, and a hobby is not thereby converted into an activity engaged in for profit.58

The court then commented on the Wrightsman case,59 observing that in that case the taxpayer could not deduct expenses connected with his art collection under section 212, although he had an investment motive in acquiring it, since his primary purpose in collecting works of art was not investment but personal pleasure. Although Wrightsman was decided before the enactment of section 183, the court stated that the same standard of primary purpose is relevant under section 183.60 Therefore, the court concluded that Stanley did not establish that investment was the most prominent purpose for her acquisition and holding of the glass novelties.

However, even though the court found in Stanley that there was no activity for profit, it did permit the deduction of collection-related expenses to the extent of the

57 See Stanley, supra note 54. See Dunn v. Comm'r, 70 T.C. 715 (1978), aff'd without published opinion 607 F.2d 995 (2d Cir. 1979); Phillips v. Comm'r, 73 T.C.M. (CCH) 2297 (1997) (Arabian horse breeding activities was profit motivated even though there was a lengthy 5 to 10 year startup loss period, and unforeseen circumstances can help a taxpayer explain profit motive in spite of low-level of activity).

58 Id.

59 See Wrightsman, supra note 13.

60 See Stanley, supra note 54.
gross income derived from the collection activities as provided by section 183(b)(2). Under the law before the passage of section 183, those deductions would have been disallowed under section 262.

Maurice C. Dreicer\(^6\) illustrates the application of section 183 and the test a taxpayer must meet to have losses allowed in an amount greater than the income received from an activity. In Dreicer the taxpayer, who received a substantial income from a family trust, had traveled extensively throughout the world for many years. Twenty years before the tax years in question, his book on international dining had been published, but, because it was a commercial failure, he had received only meager royalties. Although he had written a rough draft of a book on a similar topic during the tax years in question, he had abandoned his efforts to have it published after the manuscript had been rejected by two publishers. During the twenty years between the books, he had lectured before various travel organizations, written for a travel magazine, and participated in radio and television programs — all without compensation. The taxpayer claimed his travel and other related expenses as business expenses during the tax years in question, but the IRS disallowed the deduction on the ground that it was a hobby loss.

The Tax Court held that the taxpayer was not entitled to deduct his expenses because he did not have a bona fide expectation of profit from the pursuit of his career as a writer-lecturer. However, the appellate court ruled that, although a taxpayer's expectation of profit is a factor to be considered in determining whether losses are deductible,\(^6\) the legal standard is whether the taxpayer has engaged in the activity with the objective of making a profit. Consequently, the court remanded the case to the Tax Court for reconsideration under the profit-objective standard.

On rehearing, the Tax Court agreed with the appellate court that the correct legal standard to be applied was whether the taxpayer engaged in the activity with the objective of making a profit, not whether he had a reasonable expectation of making a profit. The Tax Court stated:

The purpose of the standard adopted by the Court of Appeals is to allow deductions where the evidence indicates that the activity is actually engaged in for profit even though it might be argued that there is not a reasonable expectation of profit. See S. Rept. 91-552 (1969), 1969-3 C.B. 423, 489-490. We are in total agreement with the Court of Appeals that

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\(^6\) See Treas. Reg. § 1.183-2(b) (listing factors to be considered by court in determining whether activity is engaged in for profit). See Khorsandi, Does Your Client Have A Profit Motive? An Analysis Of Tax Court Criteria Used To Evaluate A Taxpayer's Profit Motive Under Section 183, 47 TAX LAW. 291 (1993); Jasienski v. Comm'r, 64 T.C.M. (CCH) 1369 (1992).
this is the proper legal standard under section 183. However, a taxpayer's declaration of his motive to make a profit is not controlling. His motive is the ultimate question; yet, it must be determined by a careful analysis of all the surrounding objective facts, and greater weight is given to such facts than to his mere statement of intent. Sec. 1.183-2(a) and (b), Income Tax Regs. Thus, although a reasonable expectation of profit is not required, the facts and circumstances must indicate that the taxpayer entered into the activity, or continued the activity, with the actual and honest objective of making a profit.63

In Marie L. Johnson,64 the Tax Court seems to say that the profit requirement of section 183 is not to be applied with the same vigor in a sale-leaseback transaction as it is in a hobby-loss case.

In Dailey,65 the United States Court of Appeals for the Eighth Circuit affirmed a Tax Court opinion holding that a mere floating expectation of realizing a profit was not sufficient to satisfy section 183. The taxpayers in Dailey intended to purchase and maintain appreciating art and antiques to provide a nest egg for their retirement. However, the court held that they could not deduct as investment expenses the costs of art and antiques magazine subscriptions, a magazine-sponsored trip to Europe, or travel within the United States, since they never took any active steps to sell any items in their collection and their expectations of realizing a profit were vague and uncertain.

In S.P. Barr,66 an attorney engaged in an art-publishing enterprise, but the court found that he had no intention of making a profit. No documentary evidence was provided to corroborate his testimony that he carried on the activity in a businesslike manner. There was no evidence that he received qualified advice, and his attempts at the mail-order marketing of prints were minimal.

In J.F. Moore,67 the court allowed an attorney to deduct the ordinary and necessary expenses incurred in connection with certain bona fide sales of gemstones, but he could not deduct certain distributorship fees purportedly paid or incurred to acquire an exclusive territorial franchise for the sale of the gemstones.

64 Johnson v. United States, 86-2 U.S. Tax Cas. (CCH) 9705 (Ct. Cl. 1986).
In *J.A. Harmon*,\(^{68}\) expenses from the taxpayers' ceramics and quilting activities were allowable only to the extent of the gross income earned from those activities.

Full-time schoolteachers in *L. W. Paxton*\(^{69}\) were not permitted to deduct expenses related to the sales of their homemade craft items at craft shows in an amount exceeding the gross income derived from the activity, because they failed to demonstrate that their work was an activity engaged in for profit. The schoolteachers had net losses for the five years in question and failed to take any steps to limit the losses.

Deductions were disallowed in *M. Reali*,\(^{70}\) in which a surgeon and the owner of a private sanitation company were found not to have the requisite profit motive, under the criteria of regulation section 1.183-2(b), in connection with their lithograph-purchasing activities.

In *Stella Waitzkin*,\(^{71}\) a painter was allowed to deduct expenses as an artist engaged in artistic activities, since, on the basis of all the facts and circumstances, she had the requisite objective of making a profit, notwithstanding ten years of net losses from her artistic activities. The court recognized the personal satisfaction achieved by the taxpayer through her artistic endeavors and national gallery showings. It also recognized that the taxpayer was well-off financially and had used the long history of tax losses to offset income from other sources. Yet the taxpayer was able to dispel the characterization of her artistic activity as a hobby by showing a businesslike approach to the activity, by demonstrating her full-time commitment to it, and by convincing the court that she had achieved some commercial success and acceptance. She demonstrated a history of sales of her paintings, adequate business records, an impressive resume of gallery showings nationwide, growing commercial recognition, and a potential for appreciation in value of a large existing inventory of her artwork. Therefore, in a case involving an activity that could be primarily characterized as, and is commonly thought of as, providing the taxpayer with personal pleasure or satisfaction, the taxpayer nevertheless overcame a profit-motive challenge.\(^{72}\)

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\(^{68}\) J.A. Harmon v. Comm'r, 51 T.C.M. (CCH) 1491 (1986).


\(^{71}\) Stella Waitzkin v. Comm'r, 63 T.C.M. (CCH) 2740 (1992).

\(^{72}\) See Khorsandi, *supra* note 61. In contrast to the result of the court in Waitzkin, see William James Courville v. Comm'r, 71 T.C.M. (CCH) 2496 (1996), where the court found that an individual who spent significant time and effort in golfing activities but who failed to earn any income from those activities did not have an actual and honest objective of making a profit. Factors indicating that the taxpayer lacked a profit motive were...
In Richard A. Stasewich, an accountant claimed he was also an artist and entitled to deduct the losses from his artistic activities. Stasewich claimed that he was conducting his accounting practice only to enable him to establish himself as an artist. The question for the court was whether the artist activity was "not engaged in for profit" within the meaning of section 183(c). Whether the required profit objective exists is to be determined on the basis of all the facts and circumstances of each case. The court recited the nine factors of regulation section 1.183-2 and found particularly significant the fact that Stasewich failed to keep adequate books and records and failed to implement a business plan to reverse his continued losses. In denying the losses, the court concluded that Stasewich was motivated more by satisfaction, pride, and prestige than by the objective of earning a profit. However, the court did allow Stasewich to offset any artist-activity-related expenses to the extent of the gross income from the activity.

In Deborah Joyce Windisch, an account clerk who worked full-time at a health services agency was denied loss deductions from her photographic activities. The taxpayer maintained meticulous records, but that was not in and of itself enough to overcome the unbusiness-like manner in which Windisch carried on her photography activities. Most of her clients were family members or office-related friends, she set her prices too low to make a profit, she failed to pursue people who owed her money, and she had, the court thought, strong elements of personal pleasure and recreation in her photographic activities.

In Wilbur Kenneth Griesmer, a retired factory worker was denied any deductions related to his meteorite and pyrite collection activities. The taxpayer combed the beaches of Lake Erie searching for what he considered to be meteorites, and in particular Martian meteorites, which he believed were quite valuable. The court looked at the factors under section 183 and found that none of factors indicated that the taxpayer carried on his meteorite collecting activity with the requisite profit objective. In particular the court noted that the collecting activity was not carried on in a businesslike manner, there were no books and records of income and expenses and no part of the collection was ever offered for sale.

that he took personal pleasure in playing the game, he never worked in any capacity as a professional golfer, and he failed to qualify to participate in any Professional Golf Association tournament.


74 Id. at 5 (citing I.R.C. § 183(b)).

75 Deborah Joyce Windisch v. Comm'r, 72 T.C.M. (CCH) 361 (1996). See Klauser v. Comm'r, 60 T.C.M. (CCH) 182 (1990), where a lawyer failed to prove that his writing, photography, and law activities were engaged in for profit; Callahan v. Comm'r, 71 T.C.M. (CCH) 2103 (1996), where writing activities were not carried on in a businesslike manner.

In *Tony L. Zidar*\(^{77}\), an individual spent in excess of $100,000 to build a stock car for the American Speed Association's 1992 racing season. To make a profit from his stock car activity, Tony needed to obtain large sponsors. He could not rely on prize winnings to make a profit because drivers take a significant portion of any prize winnings. Tony had no business plan for his stock car activity, nor did he speak with any consultants about how to operate a profitable stock car business. In 1992, Tony was only able to obtain $5,571 in sponsorships. Unfortunately, while Tony was driving the stock car around the speedway between qualifying runs for a race, it collided with another race car and was destroyed. Tony had no insurance on the stock car. The Tax Court disallowed all of Tony's deductions relative to his stock car activity in excess of the $5,571 of income generated by the sponsorships, finding that Tony failed to demonstrate that he entered into the stock car activity with a good faith expectation of making a profit.\(^{78}\) The case contains a detailed analysis of the nine nonexclusive factors to be considered in determining whether an activity is engaged in for profit.\(^{79}\) In reaching its conclusion, the Tax Court placed the greatest weight on the manner of carrying on the activity, noting that Tony had no separate bank account for his stock car activity, retained no business and financial advisor to aid him with his racing activities, participated in no special exhibitions to attract financial sponsorship of large companies, and never actually raced his vehicle (except in the ill-fated qualifying round).\(^{80}\)

In *Leonard Rabinowitz*,\(^{81}\) the taxpayer, who owned a clothing business, purchased an aircraft and chartered the airplane to his business and to others at competitive rates. Despite twelve years of consistent losses, the Tax Court found that the charter aircraft business was a for-profit activity and allowed the losses. The Tax Court analyzed the facts under the nine criteria of the section 183 regulations and found particular relevant that the taxpayer maintained complete and accurate books and records and carried on the activity in a business like manner, that is, a manner substantially similar to comparable businesses that are profitable. The Tax Court took particular note that the taxpayer made changes to the jet charter activity to try to make the business profitable. It was also observed that safety problem with the aircraft and resulting

\(^{77}\) Zidar v. Comm'r, 82 T.C.M. (CCH) 357 (2001).

\(^{78}\) Id.

\(^{79}\) Treas. Reg. 1.183-2(b); Golanty v. Comm'r, 72 T.C. 411 (1979), *aff'd without published opinion* 647 F.2d 170 (9th Cir. 1981).

\(^{80}\) See and compare Mills v. United States, 699 F. Supp. 1245 (N.D. Ohio 1988) which held that a taxpayer's motorcycle racing activity was engaged in with an actual and honest profit objective. Although Mills never sustained a profit from his motorcycle racing, he had opened a separate bank account for the activity, secured a financial and business advisor and generally conducted the activity in a business-like manner. See Note, Racing Without a Profit Objective and Crashing Into Section 183: Zidar v. Commissioner, 55 Tax Lawyer 871 (2001/02).

negative publicity hampered the taxpayer's ability to obtain third-party charters. The court found the taxpayer's testimony reliable and credible and concluded that the "nine nonexclusive factors and the facts and circumstances of this case lead us to conclude that petitioners engaged in the jet charter activity with the primary, predominate and principal purpose and intent of realizing an economic profit independent of tax savings during the relevant years."\(^{82}\)

4. Section 68

If a taxpayer can carry the burden of proof that his or her art activities are engaged in for profit, the art-related expenses are deductible under section 212(1) or (2). Those expenses, if deductible, can be claimed as a miscellaneous expense on IRS form 1040, schedule A. Section 67(a) limits the deduction for such expenses to amounts that exceed 2 percent of the taxpayer's adjusted gross income.\(^{83}\) The amount of the deduction for such expenses can be further limited by section 68(a).

For tax years beginning after 1990, an individual whose adjusted gross income exceeds a specified threshold amount is required to reduce the amount allowable for itemized deductions by the smaller of (1) 3 percent of the excess of adjusted gross income over the threshold amount or (2) 80 percent of the total amount of the otherwise allowable itemized deductions.\(^ {84}\) The threshold amount for calendar year 1991 was $100,000, and the amount must be indexed for inflation for the tax years after 1991.\(^ {85}\) For 2004, the threshold amount was $142,700; for 2005, the threshold amount is $145,950.\(^ {86}\) The provision is scheduled to be phased out over a five-year period beginning in 2006 pursuant to the 2001 Tax Relief Act.\(^ {87}\) The overall limitation on itemized deductions imposed by section 68(a) will be reduced by 1/3 in tax years 2006 and 2007, and by 2/3 in tax years beginning in 2008 and 2009.\(^ {88}\) The limitation is completely repealed for tax years beginning after December 31, 2009.\(^ {89}\) The 3 percent overall limitation on itemized deductions applies only after applying other limitations on

\(^{82}\) Id.

\(^{83}\) I.R.C. § 67(a); Treas. Reg. § 1.67-I(a)(l)(iv).

\(^{84}\) I.R.C. § 68(a).


\(^{87}\) P.L. 107-16.

\(^{88}\) I.R.C. § 68(f), added by 2001 Tax Relief Act § 103, effective beginning in 2006.

\(^{89}\) I.R.C. § 68(g), added by 2001 Tax Relief Act § 103.

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26.
itemized deductions, such as the 2 percent floor on miscellaneous itemized deductions.\textsuperscript{90} That provision may have the effect of further limiting the amount of deductible art-activities expenses.

C. LOSSES

1. Losses on Sales

An individual can deduct a loss on a sale incurred in a trade or business\textsuperscript{91} or in a transaction that is not connected with a trade or business but that is entered into for profit.\textsuperscript{92} Generally, unless a collector can come within the requirements of section 183(b), as discussed above, a loss by a collector on the sale of a collection is not deductible.

A collector is someone who is not engaged in a trade or business under section 165(c)(1).\textsuperscript{93} An individual in the trade or business of buying and selling works of art is a dealer and realizes ordinary income on sales that realize a gain and has ordinary losses under section 165(c)(1) on sales that realize a loss.

The United States Supreme Court has held that investment activities do not constitute a trade or business.\textsuperscript{94} Therefore, a collector can buy and sell items and not be considered a dealer engaged in a trade or business. It must then be decided if the collector is an investor to determine whether the loss can be deducted under section 165(c)(2).

The test for deductibility under section 165(c)(2) of a loss incurred in any "transaction entered into for profit, though not connected with a trade or business," is a stricter test than that required for the deduction of expenses under section 212, under which the requirement is that an expenditure must be on property "held for the production of income."\textsuperscript{95} Therefore, satisfying section 212 does not guarantee that a loss on a sale of a collection will be deductible under section 165(c)(2). The taxpayer-collector bears the burden of proving that the transaction was entered into for profit; what is necessary is evidence that, at the time of purchase, the taxpayer acquired the collection with a profit motive.

\textsuperscript{90} I.R.C. § 68(d).
\textsuperscript{91} I.R.C. § 165(c)(1).
\textsuperscript{92} I.R.C. § 165(c)(2). See supra note 2.
\textsuperscript{93} See supra note 2.
\textsuperscript{94} See Higgins, supra note 5.
\textsuperscript{95} Horrman v. Comm'r, 17 T.C. 903 (1951); McAuley v. Comm'r, 35 T.C.M. (CCH) 1236 (1976).
In *George F. Tyler*, the taxpayer showed that from the outset he undertook stamp collecting as an investment; all purchases were made in consultation with a stamp expert. The court held that the purchase of the stamps was a transaction entered into for profit, and the loss incurred on the sale of the stamps was deductible under what is now section 165(c)(2). The case is unusual in the clarity of the fact that the taxpayer was able to offer convincing evidence of investment procedures from the outset.

Reacting to the *Tyler* case, the IRS issued Revenue Ruling 54-268, which held that a loss sustained from the sale of a collection of stamps accumulated as a hobby does not represent a loss incurred in a trade or business or in a transaction entered into for profit within the meaning of section 165(c)(1) or (2). Accordingly, the ruling holds that such a loss is not deductible for federal income tax purposes.

In *Eugene G. Feistman*, the issue was whether the losses from the taxpayer's activity known as "Feistman Stamps, Coins and Accessories" were incurred in an activity engaged in for profit. The losses resulted from expenses exceeding income and the court had to decide if the expenses were deductible under sections 162(a) or 212(1) or were nondeductible as a mere hobby. The taxpayer had litigated the issue in prior years and the tax court had held that the taxpayer's activities were a hobby and he did not have a bona fide profit motive. The court examined the current activities of the taxpayer and found that what may have started as a hobby had changed into a profit motivated activity and that the taxpayer had an "actual and honest objective of making a profit." An individual collector can deduct losses on sales as capital losses if it is proved that the collector is, in fact, an investor. However, the allowance of such a loss is extremely rare, since the taxpayer has the burden of proving that the loss-generating activity was a transaction entered into for profit and not merely a hobby.

Section 183(b) once again offers help to the collector who cannot meet the requirement of section 165(c)(2) that he or she entered into a transaction for profit. If the collector can prove that the collection is an "activity" within the meaning of section 183, capital losses are deductible under section 183(b) up to the amount of the gross income

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96 Tyler v. Comm'r, 6 T.C.M. (CCH) 275 (1947).
98 Feistman v. Comm'r, 44 T.C.M. (CCH) 30 (1982).
100 *Supra* note 93 at p. 33.
101 See *Wrightsman, supra* note 13, at 428 F.2d 1316 n.2. The loss, however, was not allowed in Wrightsman.
derived from the collection during the taxable year, after first subtracting such items as interest and taxes that are otherwise deductible without regard to section 183. Therefore, capital losses from the collection activity can be used to offset capital gains from the collection activity under section 183(b). Before the passage of section 183, the gains would have been taxable, but the losses would have been nondeductible personal losses if section 165(c)(2) was not satisfied.103

The burden of proving that the collector is engaged in a trade or business or that purchases made by the collector were made in transactions entered into for profit or in the production or the collection of income is extremely difficult. The collector should try to satisfy as many of the factual elements of regulation section 1.183-2(b) as possible. Even if the collector cannot prove a profit motive, the collector should keep adequate records to show that he or she is engaged in an activity for purposes of section 183, so that losses up to the amount of the gross income from that activity can be claimed as a deduction.

2. Losses on Inherited Property

If a collection is inherited and is immediately offered for sale and is sold at a loss, the loss is capital in nature and may be deductible under section 165(c)(2).104 However, the collection must not first be converted to personal use and thereafter offered for sale. In that situation, it becomes more difficult to show that the transaction was entered into for profit.

3. Casualty Losses

A collector may want to become a self-insurer because of the high cost of insurance for the collection. The idea behind self-insuring is that the deduction allowed for a loss from fire, theft, or other casualty may save a high-bracket taxpayer more in taxes than the cost of insurance.105 However, self-insuring may not be the best decision since the allowable casualty-loss deduction is limited to the amount that exceeds 10 percent of the taxpayer's adjusted gross income.106

Before applying the limitation, the collector must first determine the amount of the loss. The amount of the loss from a casualty is the lower of (1) the fair market value of the property immediately before the casualty, reduced by the fair market

103 I.R.C. § 262.

104 Reynolds v. Comm'r, 4 T.C.M. (CCH) 837 (1945), aff'd, 155 F.2d 620 (1st Cir. 1946) (sale of inherited jewelry); Marx v. Comm'r, 5 T.C. 173 (1945) (sale of inherited yacht); M. Assmann Estate v. Comm'r, 16 T.C. 632 (1951) (sale of inherited house); Watkins v. Comm'r, 32 T.C.M. (CCH) 809 (1973) (sale of inherited house).

105 I.R.C. § 165(c)(3), (a), (h) (effective Jan. 1, 1983); Treas. Reg. § 1.165-8.

106 I.R.C. § 165(h)(2)(A)(ii). Section 67(a)’s 2 percent limitation does not apply; see I.R.C. § 67(b)(3).
value of the property immediately after the casualty (zero in the case of a theft), or (2) the property's adjusted basis.\footnote{107}

From that lower amount, the collector must subtract $100 for each casualty\footnote{108} and then subtract 10 percent of his or her adjusted gross income.\footnote{109} Only the amount of loss that exceeds the above limitations can be claimed as a casualty loss.

For example, a collector purchased a painting for $10,000. Ten years later, when it had a fair market value of $50,000, it was stolen. There was no insurance, the taxpayer's adjusted gross income in the year of the theft was $100,000, and the theft took place during the year 1997. The casualty loss deduction is calculated as follows:

\[
\begin{align*}
\text{Amount of loss (lower of fair market value or basis)} &\quad \$10,000 \quad (a) \\
\text{Limitations: less} &\quad 100 \\
\text{less 10 percent x 100,000} &\quad 10,000 \\
\text{Amount deductible} &\quad $10,100 \quad (b) \\
\end{align*}
\]

If an item in a collection is purchased and later discovered to be a forgery and hence, almost worthless, it produces a deductible loss if the transaction amounted to a "theft" as defined by local law.\footnote{110} For it to constitute a theft, the taxpayer must bear the burden of proving that the item was sold to him or her with an intent to defraud.

4. Involuntary Conversions

Any amount of casualty loss is further reduced by any insurance recovery. If the collector receives insurance proceeds greater than the cost basis, the collector has a taxable gain\footnote{111} unless he or she can come within the exception of section 1033(a)(2). Under section 1033(a)(2), a gain from an involuntary conversion of property into money is not recognized if the insurance proceeds were used to purchase similar property (similar to the items collected) within two years after the close of the first taxable year in which any part of the gain on conversion was realized.\footnote{112}

\footnotesize
\begin{itemize}
\item \footnote{107} Treas. Reg. § 1.165-7(b).
\item \footnote{108} I.R.C. § 165(h)(1)(A).
\item \footnote{109} I.R.C. § 165(h)(1)(B).
\item \footnote{110} I.R.C. § 165(c)(3); Treas. Reg. § 1.165-8; Gerstell v. Comm'r, 46 T.C. 161 (1966); Krahmer v. United States, 810 F.2d 1145 (Fed. Cir. 1987), aff'd in part and rev'd in part 85-2 U.S. Tax Cas. (CCH) | 9970 (Cl Ct. 1985).
\item \footnote{111} I.R.C. § 1231(a); Treas. Reg. § 1.1033(a)-1(a).
\item \footnote{112} I.R.C. § 1033(a)(2).
\end{itemize}
In the above casualty-loss example, if the collector has a $50,000 insurance recovery on the painting, he or she has a realized taxable gain of $40,000, unless he or she reinvests the insurance proceeds in similar property within the applicable time period of section 1033(a)(2).

The question of what is similar property for a collector was dealt with in Private Letter Ruling 8127089. A fire had caused extensive damage to a collector's lithographs and other art items. The collector had difficulty in replacing the lithographs and wanted to use part of the insurance proceeds to purchase artwork in other artistic media. The IRS ruled that artwork in one medium that is destroyed in whole or in part and that is replaced with artwork in another medium will not be considered property similar or related in service or use. The Private Letter Ruling appears to be unduly narrow in its interpretation of the statute.

D. EXCHANGES

It is a common practice for collectors to exchange items, each intending to improve his or her collection. Dealers often encourage collectors to trade in works of art purchased from them in exchange for other works of art. Section 1031(a) allows certain "like-kind" exchanges to be made tax free. The statute limits such exchanges to property held for productive use in a trade or business or for investment that is exchanged solely for property of a like-kind to be held for productive use in a trade or business or for investment. Accordingly, there are four requirements for a like-kind exchange to be tax free under section 1031(a): (i) there must be an "exchange"; (ii) the exchange must be of "property" of a type that qualifies under section 1031(a); the replacement property must be of "like-kind" to the property relinquished; and (iii) both the relinquished property and the replacement property must be held for productive use in a trade or business or for investment. The general rule of section 1031(a) requires that qualifying property must be exchanged solely for other qualifying property. If an exchange would otherwise be eligible for tax free treatment under section 1031(a) but for the receipt of cash (boot), any gain realized on the exchange is recognized to the extent of the boot received.

In the usual case, a collector is engaged in a hobby, not a business. The collector may argue that he or she is an "investor" and held the property for investment.

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114 I.R.C. § 1031(a)(2) provides that the properties involved in a like-kind exchange may not be stock in trade or other property held primarily for sale (inventory), stocks, bonds or notes, other securities or evidence of indebtedness or interest, interests in a partnership, certificate of trust, or beneficial interests or choses in action. Therefore, an exchange between an art dealer and a collector, if all requirements are satisfied, may be tax free to the collector but will be taxable to the art dealer. See Rev. Rul. 75-292, 1975-2 C.B. 333.

115 I.R.C. § 1031(b); Coleman v. Comm'r, 180 F.2d 758 (8th Cir. 1950).
The term "investment" is not defined in section 1031.\textsuperscript{116} In light of \textit{Wrightsman} and sections 162, 165, 212, and 183, the term most likely means property held primarily for profit. The burden of proof for the collector who wants to be an investor may be difficult because of the lack of authorities and because of differences in terminology.\textsuperscript{117} With the increases in values for top quality works of art and dissatisfaction with the stock market many individuals are investing substantial sums in works of art. When a collector pays one million, five million or ten million dollars for a work of art, it is only logical to assume that there's some investment objective when the acquisition is made and that the work of art is being held for investment. Regulation section 1.1031(a)-1(b) indicates that unproductive real estate that is held by a nondealer for future use or future realization of the increase in value is property held for investment. The test is applied at the time of the exchange without regard to the taxpayer's motive before the exchange.\textsuperscript{118} With the present long-term capital gain rate at 28\% for gain from the sale of collectibles, there is increased motivation for collectors to come within the tax-free exchange provisions of section 1031(a). For the collector the difference between the fair market value of the property received and the basis of the property given up results in a taxable gain. The investor, however, may be able to avoid any taxable gain under the umbrella of section 1031(a).

Even if a taxpayer can carry the difficult burden of proof of being an investor, the exchange may still have the problem of what constitutes "like-kind" property. The IRS has ruled, for purposes of section 1033 (the provision pertaining to involuntary conversions), that lithographs may not be replaced with artworks in "other artistic media" such as oil paintings, watercolors, sculpture or other graphic forms of art.\textsuperscript{119} The ruling seems unduly narrow and there is no indication if the same result would apply under section 1031(a).\textsuperscript{120} Under section 1031(a) the words "like-kind" refer to the nature or character of the property and not to its grade or quality. One work of art should be able to be exchanged for another work of art, even in a different medium, since the nature or character of the properties as "works of art" are the same.\textsuperscript{121}

\textsuperscript{116} See supra notes 6 through 11 and the accompanying text.

\textsuperscript{117} Compare I.R.C. §§ 162, 165, 212, 183, with I.R.C. § 1031(a).

\textsuperscript{118} Rev. Rul. 57-244, 1957-1 CB 247 where the IRS ruled that unimproved real estate qualified for a like-kind exchange where the taxpayer abandoned his original intention to construct a personal residence on it and, thereafter, held it only for investment.

\textsuperscript{119} Priv. Ltr. Rul. 8127089.

\textsuperscript{120} In a 1992 Field Service Advice, the IRS National Office stated they will not rule on the issue unless forced to do so on audit. FSA from Branch 5 of Office of Chief Counsel, Income Tax and Accounting, dated 11/25/92.

\textsuperscript{121} Id.; Rev. Rul. 76-214, 1976-1 C.B. 218 (exchange of noncurrency bullion-type gold coins of one country for noncurrency bullion-type gold coins of a second country is "like-kind" because it is the exchange of bullion-type coins for bullion-type coins). See also, Rev. Rul. 79-143, 1979-1 C.B. 264; Priv. Ltr. Rul. 8117053. In Rev. Rul. 82-166, 1982-2 C.B. 190, the IRS ruled that gold bullion held for investment and silver...
Initially, section 1031 was designed to apply to simultaneous transfers of like-kind property between two persons. The rules have evolved to allow multiparty exchanges and deferred exchanges. In a multiparty exchange, an exchange agent facilitates the exchange. For example, Collector A owns painting X and wants to acquire painting Y owned by Collector B. Collector B does not want painting X; Collector B wants cash. So Collector A transfers title to painting X (the relinquished property) to exchange agent C. Exchange agent C sells painting X and uses the proceeds to buy painting Y (the replacement property) from collector B and then transfers title to painting Y to Collector A in payment for painting X. This type of exchange is sometimes referred to as a Starker transaction after *Starker v. U.S.*\(^{122}\) where the court sanctioned the taxpayer's transfer of property in exchange for a promise by the recipient to convey like-kind property chosen by the taxpayer at a later date. Following the decision in *Starker*, Congress enacted section 1031(a)(3) which allows the transferor of the relinquished property up to 45 days to identify the replacement property and 180 days to close on the acquisition of the replacement property. The taxpayer may identify as replacement property any three properties or multiple properties with a fair market value not in excess of 200% of the fair market value of the relinquished property.\(^{123}\)

The regulations\(^{124}\) under section 1031(a)(3) set forth detailed guidance concerning how a taxpayer can comply with the tax free like-kind deferred exchange requirements, including four "safe harbors" that taxpayers can rely on to avoid constructive receipt of the proceeds from the sale of the relinquished property.\(^{125}\) Each of the safe harbor regulations\(^{126}\) contains highly technical and complex provisions, made more so since they were promulgated in anticipation of the exchange of real property and not collectibles. For example, under the third safe harbor, the taxpayer's transferee must be a "qualified intermediary."\(^{127}\) A qualified intermediary is a person who is not the taxpayer or a "disqualified person" and who enters into an exchange agreement with the

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\(^{122}\) *Starker* v. U.S., 602 F.2d 1341 (9th Cir. 1979).

\(^{123}\) Treas. Reg. § 1.1031(l)-l(c)(4).

\(^{124}\) Treas. Reg. § 1.1031(k)-l.

\(^{125}\) The regulations are based on typical deferred exchanges transactions pertaining to exchanges of real estate. Treas. Reg. § 1.1031(k)-l provides four safe harbors which state that certain issues, such as agency and constructive receipt will, in effect, be ignored for purposes of determining whether the taxpayer is in actual or constructive receipt of money or other property before the taxpayer actually receives like-kind replacement property. These safe harbors have resulted in the creation of an entire industry of "qualified intermediaries" willing to act (for a fee) to assist taxpayers in completing deferred exchanges that are nontaxable under I.R.C. § 1031.

\(^{126}\) Treas. Reg. § 1.1031(k)-l.

\(^{127}\) Treas. Reg. § 1.1031(k)-l(g)(6); Treas. Reg. § 1.1031(k)-l(g)(4)(i), (ii).
taxpayer and, as required by the exchange agreement, acquires the relinquished property from the taxpayer, transfers the relinquished property, acquires the replacement property, and transfers the replacement property to the taxpayer.  

A "disqualified person" is a person (i) who is the agent of the taxpayer at the time of the transaction, (ii) who is related to a person as described in either section 267(b) or section 707(b), or (iii) the person described in (i) has such a relationship described in (ii) of this sentence. Persons who acted as the taxpayer's employee, attorney, accountant, investment banker or broker, or real estate agent or broker during the two year period immediately preceding the taxpayer's transfer of the relinquished property are treated as agents of the taxpayer at the time of the transaction. Again, the regulations and rulings are complex and technical as to who is or is not an agent of the taxpayer under the safe harbor provision. Although there is no specific authority, it appears that an art dealer can act as a qualified intermediary and not be a disqualified person. Because of the uncertainty involved, it is important that title to the relinquished property be transferred to the art dealer at a specific stated value and that the art dealer have the freedom to sell the relinquished property in order to use the proceeds to acquire the replacement property. Any amount received by the art dealer on the sale of the relinquished property in excess of the stated value should belong to the art dealer. It is preferable to use an art dealer who has not acted as the taxpayer's agent through a consignment of a collectible during the two years prior to the contemplated exchange transaction.

No recent cases or IRS rulings have shed light on the meaning of the terms in section 1031(a). Generally, a collector has great difficulty in carrying the burden of proof under section 1031, since he or she must prove that a painting, say, was held for investment and was exchanged for a painting that was held for investment. Accordingly, most exchanges of appreciated works of art are taxable. However, if the investment objective can be satisfied, there is no reason why the collector can not take advantage of a

128 Treas. Reg. § 1.1031 (k)-1 (g)(4)(iii).
129 Treas. Reg. § 1.1031(k)-1(k)(2).
130 Treas. Reg. § 1.1031(k)-1(k)(3).
131 Treas. Reg. § 1.1031(k)-1(k)(4).
132 Treas. Reg. § 1.1031(k)-1(k)(2).
section 1031(a) tax free exchange. The technical requirements and potential pitfalls are numerous and a full description is well beyond the scope of this article.\textsuperscript{134} All exchanges do require a written exchange form. One important development is the requirement that a taxpayer who enters into a like-kind exchange as of January 1, 1990, must file IRS form 8824. The form reveals to the IRS all the details about the exchange and calls attention to exchanges that heretofore may have gone unnoticed by the IRS.

Whether an exchange is a taxable or nontaxable transaction for federal income tax purposes, it is treated as a sale for sales tax purposes, and a sales tax may be payable on the exchange.\textsuperscript{135} Generally, if the exchange is between a collector and a dealer, each collector should collect and pay over the sales tax. If the exchange is between a dealer and a collector, the dealer should collect and pay over the sales tax to the extent of the cash required from the collector to complete the exchange.\textsuperscript{136} The sales tax provisions are explained in more detail below.

E. SALES AND USE TAXES

Dealers — those individuals who, on the basis of all the facts and circumstances, are engaged in the trade or business of buying and selling works of art\textsuperscript{137} — must register with the state sales tax department and obtain a resale certificate and number from the state in which the dealer is doing business. With a resale number, the dealer is not required to pay a sales tax on works of art purchased in any state, since the works purchased are being bought for resale. When the dealer sells the works purchased, the dealer then collects the sales tax from his or her customer — that is, the sales tax is paid by the ultimate consumer, who is usually the investor or the collector. The sales tax is a transaction tax, liability for which occurs when the transaction takes place.

A use tax is designed to complement the sales tax, and imposes a tax on the use within a state of works of art (or other items of tangible personal property) that would have been subject to the sales tax if they were purchased within the state. This means that an investor or collector who resides in one state, and buys an artwork in another state for delivery in the state where he or she resides, will owe a use tax to the state in which he or she is a resident. In this situation, a sales tax would not be due in the state where the purchase was made.

Sometimes the investor or the collector of artworks who may buy and sell a work from time to time attempts to avoid paying the sales or use tax by registering for a resale certificate and number, either in his or her own name or in the name of a

\textsuperscript{134} Id.

\textsuperscript{135} See, e.g., 20 N.Y. COMP. CODES R. & REGS. §§ 526.5(f), 526.7(d).

\textsuperscript{136} See discussion of sales tax below.

\textsuperscript{137} See supra note 4.
corporation set up for that purpose. Doing so is usually a big mistake since, at best, the
artworks purchased will be ordinary-income property that will produce ordinary income
and not capital gain if sold, and a deduction will be limited to the artwork's cost if
donated to charity. At worst, the investor or collector could face possible criminal
charges.

Although an analysis of the sales tax law in every state is beyond the scope of this article, a review of the law as it applies in New York State can serve as a guide for dealers, investors, and collectors in all states. The references below are to the New York State sales tax statute and regulations thereunder.

1. **Sale of Art**

   The New York State sales tax must be paid by the buyer and collected by the seller on the sale of tangible personal property in the state unless (1) the property is sold to a buyer for delivery out of the state of New York or (2) it is purchased by a dealer exclusively for resale.\(^\text{138}\)

   \( \text{i. Delivery out of State} \)

   The New York State sales tax law does not provide any specific exemption from the New York State sales tax for sales of tangible personal property delivered to purchasers outside New York State. However, such transactions are exempt from the sales tax for constitutional reasons pursuant to the commerce clause of the United States Constitution,\(^\text{139}\) provided that the out-of-state purchaser does not take delivery in the state of New York.

   The sales tax is a transactional tax that is based on the situs where a delivery is made or possession is transferred from the seller to the purchaser. Regulation 525.2(a)(3) provides the following:

   "The sales tax is a "destination tax," that is, the point of delivery or point at which possession is transferred by the vendor to the purchaser or designee controls both the tax incident and the tax rate."\(^\text{140}\)

   Thus, the sales tax applies only to sales in which delivery takes place within New York State.

   Regulation 526.7(e)(1) provides the following:

\(^{138}\) N.Y. TAX LAW § 1105(a).


\(^{140}\) N.Y. TAX LAW-Reg. § 525.2(a)(3).
A sale is taxable at the place where the tangible personal property or service is delivered, or the point at which possession is transferred by the vendor to the purchaser or his designee.\textsuperscript{141}

If the selling art dealer ships a work of art by common carrier to the purchaser, the sale (the taxable event) occurs where delivery is made to the purchaser. In Advisory Opinion TSB-A-89, the seller of audio-video equipment shipped its merchandise by common carrier from the seller's location directly to the customer in Florida. The customer was billed for the equipment and, presumably, for the shipping cost. The opinion holds that the New York sales tax does not apply.\textsuperscript{142} In \textit{Matter of the Petition of Richard L. Feigen & Co., Inc.},\textsuperscript{143} there are five examples of sales of art that were not subject to the New York State sales tax. The decision specifically covers works of art that were delivered by common carrier to an out-of-state purchaser that were not, under various fact situations, subject to the New York sales tax. The decision is not completely clear as to whether it is necessary for the dealer to be the person who hires and pays the common-carrier fees.

In order to avoid collecting the New York State sales tax, an art gallery is required to deliver the work of art to the purchaser out of New York State. The clearest case is one in which the art gallery delivers the work by a common carrier hired by the gallery and the common-carrier invoice is rendered to the gallery. The art gallery can seek reimbursement from the out-of-state purchaser. It also appears that the New York State sales tax should not apply, even if the purchaser selects the common carrier and is invoiced directly for the costs, so long as it is the art gallery that delivers the work to the common carrier. In the latter case, the art gallery is still required to have documented proof that it shipped the work by common carrier to the out-of-state purchaser. Therefore, if the purchaser wants to select the common carrier, it is always best if the art gallery is the entity that retains the common carrier at the request of the purchaser, even if the cost is to be paid by the purchaser.

Art galleries, among other entities, have been targeted by the New York State sales tax department for specific investigation for sales taxes due.\textsuperscript{144} In the course of a sales tax audit, the agents check invoices and points of delivery, look to see if the bill

\textsuperscript{141} N.Y. TAX LAW-Reg. § 526.7(e)(1).


\textsuperscript{144} The Manhattan District Attorney's office has been conducting an intense investigation of art dealers and collectors who may be in violation of New York State's Sales and Compensating Use Tax Law. For information on those art dealers who have pled guilty to a violation see the website manhattanda.org/whatsnew/index.htm. The continuing investigation has raised millions of dollars for New York State. \textit{See} N.Y. Times, A Tax That's Often Ignored Suddenly Attracts Attention, June 5, 2002.
of lading includes the weight of the item delivered, and take other steps to verify the interstate elements of the transaction.

If a purchaser has an item shipped to an out-of-state location, that individual may have a use tax liability in the state of delivery. Under certain circumstances, if that individual later brings the item back into New York State, it is possible that New York State could impose a use tax. Those situations do not involve the responsibility of the art gallery unless it can be shown that the art gallery conspired in some way to assist the purchaser in avoiding the New York State sales tax.

\textit{ii. Purchase Exclusively for Resale}

Robert Guccione, well-known as the publisher of \textit{Penthouse} magazine, found out how stringently the sales tax provisions can be applied in the case of \textit{P-H Fine Arts, Ltd}. Guccione pursued his interest in art with the purchase of works by Pablo Picasso, Edgar Degas, Marc Chagall, Amedeo Modigliani, Pierre-Auguste Renoir, Chaim Soutine, Salvador Dali, and other great artists. He incorporated P-H Fine Arts, Ltd. as a wholly owned subsidiary of \textit{Penthouse} magazine for the purpose of buying and selling fine art. The works of art were hung in Guccione's town house for the purpose of creating a certain image in the eyes of corporate clients until the paintings could be sold. The town house was not open to the public, there was no price list, and Guccione never told anyone that the artwork was for sale. Furthermore, he kept no general ledger or sales journal, since the accountants for Guccione said that such records were unnecessary, because there were so few transactions. Therefore, after an audit the New York State Tax Commission took the position that the art was not purchased for resale. The unique defense put forth by Guccione was that, by not telling anyone that the paintings were for sale, a great desire to own the paintings was created in the persons who had the opportunity to see them. Guccione testified as follows:

He wants it [a painting] more now that he knows it is not for sale, and now, knowing how good it is and hearing from Ron who is an expert as well — he is really interested.

Surprisingly, the court found that P-H Fine Arts proved that the artwork was purchased for resale. However, the court said that was not the end of the analysis. The court's interpretation of the sales tax law was that P-H Fine Arts had to prove that the intention of reselling the artworks was the only purpose for which the artworks were acquired. Therefore, the court concluded that P-H Fine Arts intended to use the artwork

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147 Id. at *19.
for a purpose other than resale: to allow the artwork to be displayed in a setting where it served the business interests of *Penthouse* and Guccione. At the time the artworks were purchased, Guccione had at least two purposes for the acquisition: resale and use by him and *Penthouse;* therefore, the artworks were not purchased *exclusively* for resale.\(^\text{148}\) As a result, Guccione was required to pay more than $500,000 in sales tax.

### iii. Trade-in Credit

The federal income tax provisions related to tax free like-kind exchanges under section 1031(a) were discussed earlier in this article. Even if a collector fails to satisfy the technical provisions of section 1031(a) so that the gain on the exchange is taxable, there will be a savings on the sales tax payable if the collector exchanges the artwork with a dealer. The New York State sales tax law provides that any allowance or credit for tangible personal property accepted in part payment by a vendor on the purchase of tangible personal property or services and intended for resale by the vendor is to be excluded when arriving at the receipt subject to the sales tax.\(^\text{149}\) For example, a Collector owns painting A that cost $10,000 and is now worth $50,000. The Collector goes to an art dealer who is will to allow the Collector a $50,000 trade-in credit against the Collector's purchase of painting B worth $100,000. The art dealer agrees to accept painting A as a trade-in and intends to resell painting A at a future date. The New York sales tax is calculated as follows:

\[
\begin{align*}
\text{Painting B-sold to Collector} & \quad $100,000.00 \\
\text{less: trade-in credit for painting A} & \quad 50,000.00 \\
\text{Net amount due art dealer} & \quad 50,000.00 \\
\text{sales tax—(8.375% in NYC on 50,000)} & \quad $4,187.50 \\
\end{align*}
\]

If there was no trade-in credit the sales tax would be based on $100,000 for a sales tax of $8,375.00 — the New York City sales tax rate being 8.375% effective June 1, 2005. The sales tax will vary from county to county in New York State and the applicable tax rate should always be checked since it changes from time to time. If the trade-in qualified as an exchange under section 1031(a) there would be no federal income tax on the difference between the Collector's cost of painting A ($10,000) and the trade-in credit or current value of painting A ($50,000). If the trade-in failed to qualify under section 1031(a), the Collector would owe an income tax on the difference between his cost for painting A of $10,000 and the trade-in credit for painting A of $50,000. The ideal situation for the collector is to satisfy both the section 1031(a) provisions for federal income tax purposes and the trade-in credit rule for New York State sales tax purposes. The availability of the state trade-in credit should always be checked since it is not available in every state.

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\(^\text{148}\) Id. at *33.

\(^\text{149}\) N.Y. TAX LAW-Reg. § 526.5(f).

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39.
The above result does not work if two collectors exchange paintings since only a vendor who accepts property as a trade-in with the intent to resell it can allow a trade-in credit free of the New York sales tax.\textsuperscript{150}

2. Advice on Purchase or Sale

Interior decorating and design services are subject to the New York sales tax,\textsuperscript{151} but an art advisor's service of consulting with a client solely for the purpose of recommending whether the client should purchase certain works of art from an investment-potential perspective is not a taxable interior decorating and design service.\textsuperscript{152} It is not always clear where the line is drawn between art-advisory services that are subject to the sales tax and those that are not taxable.

When the art adviser advises a private collector within New York regarding quality and investment potential of art acquisitions with respect to specific artists and artworks, the art adviser is considered to be performing a consulting service. When the art adviser advises the client on the proper framing of an artwork and on the restoration procedure for such artwork without performing or arranging for the actual framing or restoration service, the art adviser is also considered to be performing a consulting service. The receipts from charges billed to the client for such consulting services are not subject to New York sales tax.\textsuperscript{153}

However, when the art adviser supervises the installation of the artwork within the client's home, the art adviser is considered to be performing interior decorating and design services, and the total charges to the client, including charges for the above-noted consulting services, are subject to the New York sales tax.\textsuperscript{154}

3. Purchase at Auction

When a work of art is purchased at Sotheby's or Christie's or most other auction houses, the buyer pays a fee over and above the hammer price that is known as the buyer's premium.\textsuperscript{155} Publishing mogul Samuel D. Newhouse, Jr., argued that the 10

\textsuperscript{150} N.Y. TAX LAW-Reg. § 526.7(d). Example 1 of this Regulation provides: A and B exchange automobiles. The exchange is a sale under the Tax Law and each party is liable for the payment of the tax measured by the current market value of the automobiles received.

\textsuperscript{151} N.Y. TAX LAW § 1105(c)(7). The New York City sales tax on such services was repealed effective December 1, 1995.


\textsuperscript{153} Id.

\textsuperscript{154} Id. N.Y. TAX LAW § 1105(c)(7).

\textsuperscript{155} The buyer's premium at both Sotheby's and Christie's is 20% on the first $200,000 and 12% on the amount above $200,000.
percent buyer's premium ($1,550,000) on his purchase at auction of Jasper Johns's *False Start* for $15.5 million was not subject to the New York sales tax, since it was not part of the purchase price but a fee paid for a separate service. In *In re Newhouse*\(^{156}\) the court decided otherwise, holding that the buyer's premium was an integral aspect of Newhouse's purchase of the painting. The court agreed with the position of the New York sales tax department that at the auction all charges actually paid by the purchaser as a result of the sale of tangible personal property or the rendition of a service are subject to tax.\(^ {157}\) The court stated:

There can be little doubt that [Newhouse's] purchase of *False Start* at a Sotheby's auction lends his purchase a special distinction given Sotheby's history, founded in 1744, and well-known name in fine arts. Therefore, the 10 percent "buyer's premium" may reasonably be viewed as the cost incurred by petitioner to purchase the painting at Sotheby's . . . which added luster and value to the transaction. Therefore, the "buyer's premium" is an integral aspect of petitioner's purchase of the painting and was not a separate service arising from a different transaction.\(^ {158}\)

II. PENSION PROTECTION ACT OF 2006 - ART WORLD PROVISIONS

The Pension Protection Act of 2006\(^ {159}\) (hereafter the "PPA") added new section 170(e)(7)(A) that provides if a charitable organization receives appreciated tangible personal property as a charitable contribution and disposes of the property within three years of receiving it, the donor may not derive any tax benefit beyond a deduction in the amount of the property's basis.\(^ {160}\) However, this rule will not apply if the donee provides a "certification" from the donee charity that the property was intended to be used or was put to a use related to the donee's exempt purpose.\(^ {161}\)


\(^{157}\) Id., citing *In re Penfold v. State Tax Comm'n*, 494 N.Y.S.2d 552 (1985), involving a refuse company that had a dumping charge that claimed the charge was a separate, nontaxable service. There the court ruled, "The record is clear that the petitioner's customers purchased but one service, the removal of refuse. Disposal of that refuse is, in our view, an integral aspect of that service and cannot reasonably be reckoned a separate service arising from a different transaction."

\(^{158}\) *See supra* note 155.


\(^{160}\) I.R.C. § 170(e)(7)(C).

\(^{161}\) I.R.C. § 170(e)(7)(B).
A. RELATED USE RULE

The related use rule applies to capital gain property that is tangible personal property contributed to a public charity. The term "tangible personal property" includes paintings and art objects not produced by the donor. The related use rule requires that the use of the tangible personal property by the donee organization be related to the purpose or the function constituting the basis for the donee's exemption under section 501. If the use of the collection by the donee organization is unrelated to the purpose or the function constituting the basis for the donee's exemption, the amount of the charitable deduction must be reduced by 100% of the appreciation in value of the collection.\(^{162}\) In that instance, after the 100% appreciation reduction, the remainder may be deducted up to 50% of the taxpayer's contribution base.\(^{163}\)

One of the major changes made by the Tax Reform Act of 1986 was the amendment of section 170(e)(1) so that 100% of the appreciation in value is lost as a charitable deduction if the related use rule is not satisfied. The new rule is effective for contributions made on or after January 1, 1987. Under the law in effect before January 1, 1987, only 40% of the appreciation in value was lost as a charitable deduction. Therefore, a taxpayer must be careful to comply with the related use rule; otherwise, the charitable deduction for appreciated long-term capital gain property that is tangible personal property will be limited to his cost.

The regulations\(^{164}\) provide that a taxpayer may treat the contribution of a collection as meeting the related use rule if:

1. The taxpayer establishes that the collection is not in fact put to an unrelated use by the donee; or if,

2. At the time of the contribution, it is reasonable to anticipate that the collection will not be put to an unrelated use by the donee organization.

If a collector donates a collection to a museum and the collection is of a general type normally retained by museums for museum purposes, it is reasonable for the donor to anticipate, unless he has actual knowledge to the contrary, that the collection will not be put to an unrelated use by the donee, whether or not the collection is later sold or exchanged by the donee. However, if an item is donated for the purpose of sale at an art auction to be run by the charity, that is an unrelated use, and 100% of the appreciation in value is lost as a charitable deduction.

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\(^{163}\) I.R.C. §§ 170(b)(1)(A); (c)(1).

\(^{164}\) Treas. Reg. § 1.170A-4(b)(3)(ii), i.
Example 1: A painting contributed to an art museum that is a public charity and that can and, in fact, does from time to time display the painting prominently and publicly satisfies the related use rule. The contribution is deductible to the extent of the fair market value of the property within the 30% limitation.

Example 2: If the same painting is contributed to the Red Cross, which is a public charity and which from the outset intends to sell the painting and, in fact, promptly does sell it, the deduction must be reduced by 100% of the appreciation in value, with the balance deductible within the 50% limitation.

The regulations\(^{165}\) also indicate that the related use rule is met even if the donee sells or otherwise disposes of only an "insubstantial" portion of the collection.

To date there have been few litigated cases on the subject of related use. However, a number of Private Letter Rulings in this area do shed some light on what the IRS considers a related use.

Private Letter Ruling 77-51-044

The IRS held that the related use sale was satisfied when lithographs were displayed in a camp and center devoted to handicapped and retarded children, since the lithographs were used in connection with an art appreciation program. (Private Letter Rulings 79-11-109 and 79-34-082 reach similar results in dealing with the exhibition of works of art.)

Private Letter Ruling 80-09-027

The IRS held that the related use rule was not satisfied when a donor gave an antique car to a university, since the university did not offer a course in antique car restoration.

Private Letter Ruling 81-43-029

The IRS held that the related use rule was satisfied when a donor gave his collection of porcelain art objects to a public charity operating a retirement center, since the display of the art was related to the charity's exempt purpose of creating a living environment for its residents.

Private Letter Ruling 82-08-059

The IRS held that the related use rule was satisfied when a donor gave his stamp collection to a college, since it would be exhibited and the college had, as part of

its curriculum, the teaching of engraving skills. In the ruling request the donor included letters from the college, explaining in detail how it would use the collection.

Private Letter Ruling 91-31-053

The IRS held that the related use rule was satisfied when a donor gave seeds, greenhouses, plants, livestock, animal semen, beds, desks, tilling equipment, and cafeteria equipment to a private school with exempt status under sections 501(c)(3) and 509(a)(1). The donated items of tangible personal property were to be used by the school in its plant science and animal science curriculum.

Private Letter Ruling 98-33-011

The IRS held that the related use rule was satisfied when a donor donated paintings to a Jewish community center that was not a museum but did have an arts wing and library. The community center proposed to solicit contribution of works of art that would be selected by a group of volunteers from the local community but would not be restricted to Jewish artists or to Jewish themes. The community center would accept only works of art that it expected to use in a manner related to the purpose or function constituting the basis for the community center's exemption under section 501(c)(3). The community center would display some of the works of art, and others would be put on loan with affiliated charitable organizations. The community center represented that it did not intend to sell the donated works of art except on a limited and infrequent basis when the collection exceeded the space available for display or an item was no longer relevant or it became too costly to provide maintenance and security for the work of art. The Private Letter Ruling held that so long as any loans to other charitable organizations further the community center's exempt purpose or function, then such activities will not be unrelated to the exempt purpose of the community center. However, the IRS pointed out that the community center may not rely on the exempt purpose or function of the charitable organization to which the works of art are loaned. The purpose of the loan must be to further the exempt purpose of the community center.

It is important to make sure that a proper paper trail shows that it was reasonable for the taxpayer to anticipate that the property would not be put to an unrelated use by the donee.166

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1. Related Use Reporting

Prior to the PPA the IRS required the donee charity to file IRS form 8282 if the donee charity disposes of the property within two years of receipt. Presumably this would give the IRS the opportunity to audit the donor-taxpayer's income tax return if the price the donated item was sold for was less than the deduction claimed by the donor. Under the PPA the reporting requirement is increased to apply to dispositions made within three years after receipt by the donee charity. Obviously, there is a new focus on the actual use the charity makes of the donated property. In addition, the information that must be reported now includes a description of the donee's use of the property and a statement indicating whether its use was related to its exempt purpose or function. If the donee charity does indicate a related use, it must include with the disclosure form the certification discussed below. Form 8282 was revised as of April 2009.

Where there is no "certification" and a donee organization sells, exchanges, or otherwise disposes of the applicable property in the donor's tax year in which the contribution was made, the donor's deduction is limited to basis and not fair market value. If the donated property is disposed of by a donee organization in a subsequent year within three years of the contribution, the donor must include as ordinary income for the year in which the disposition occurs an amount equal to the excess (if any) of (i) the amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property, over (ii) the donor's basis in such property at the time of the contribution.

The limitation on the deduction in the first tax year or the recapture of the tax benefit in a subsequent year does not apply if the donee organization makes a "certification" to the IRS. A certification is a written statement signed under penalty of perjury by an officer of the donee organization which either—

(1) certifies that the property's use was related to the donee's exempt purpose or function and describes how the property was used and how such use furthered the exempt purpose of function; or

(2) states the intended use of the property by the donee at the time of the contribution and certifies that such intended use became impossible or infeasible to implement.

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167 I.R.C. § 6050L(a)(1).
168 I.R.C. § 170(e)(7).
170 I.R.C. § 170(e)(7)(D).
In essence, the claim that donated property was put to an exempt use now triggers much more scrutiny if the donee organization does not retain that property at least until the end of the third year after the property was donated.

These new rules do not apply to any contribution of exempt use property with a claimed value of $5,000 or less.

2. Related Use Penalty

In conjunction with the new recapture rules discussed above, there is a new penalty for the fraudulent identification of exempt use property. In addition to any criminal penalty, any person who identifies applicable property (as defined in section 170(e)(7)(C)) as having a use that is related to the donee's exempt purpose or function and who knows that the contributed property is not intended for such a use, is subject to a $10,000 penalty.

B. QUALIFIED APPRAISAL

The PPA revised the definition of a "qualified appraisal" to mean an appraisal of property which is:

1. treated as a qualified appraisal under the regulations or other guidance prescribed by the IRS; and
2. conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the IRS.

Effective for returns filed after February 16, 2007, the appraisal must contain a declaration that the appraiser understands that a substantial or gross valuation misstatement resulting from an appraisal of the value of property that the appraiser knows, or reasonably should have known, would be used in connection with a return or claim for refund, may subject the appraiser to a civil penalty under section 6695A. This statement is in addition to the requirement that the appraisal contain a statement that the appraiser understands that an intentionally false or fraudulent overstatement of the value of the appraised property may subject the appraiser to civil penalty under IRC § 6701 for aiding and abetting an understatement of tax liability.

The existing IRC regulations still apply requiring that the appraisal not be prepared more than sixty days before the date of the contribution of the appraised property and that the appraisal be signed and dated by a qualified appraiser who charges

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171 I.R.C. § 6720B.


an appraisal fee that is not based on a percentage of the value of the appraised property.\textsuperscript{174}

The qualified appraisal must contain the following information:

1. A detailed description of the property
2. The physical condition of the property
3. The date or expected date of the contribution
4. The terms of any agreement or understanding entered into or expected to be entered into by or on behalf of the donor that relates to the use, sale, or other disposition of the property contributed
5. The name, address, and taxpayer identification number of the appraiser
6. A detailed description of the appraiser's background and qualifications
7. A statement that the appraisal was prepared for income tax purposes
8. The date on which the property was valued
9. The appraised fair market value of the property
10. The method of valuation used to determine the fair market value
11. The specific basis for the valuation, such as any specific comparable sales transactions
12. A description of the fee arrangement between the donor and the appraiser

Obviously, the cost to the taxpayer of having a qualified appraisal prepared is going to be high because of the detailed information required. A separate qualified appraisal is required for each item of property that is not included in a group of similar items of property. If the appraisal is for a group of similar items, the detailed information is required for each individual item other than items worth less than $100, for which a group description is allowed.

The qualified appraisal must be received by the donor before the due date (including extensions) of the taxpayer's income tax return.\textsuperscript{175} That deadline is important,

\textsuperscript{174} Treas. Reg. § 1.170A-13(c)(3).

\textsuperscript{175} Treas. Reg. § 1.170A-13(c)(3)(iv)(B).
since the entire charitable deduction is lost if the taxpayer does not comply with that provision.

C. QUALIFIED APPRAISER

The PPA now includes in the Internal Revenue Code a definition of a "qualified appraiser" to mean an individual who:

1. has earned an appraisal designation from a recognized professional appraiser organization, or has otherwise met minimum education and experience requirements set forth in regulations;
2. regularly performs appraisals for pay; and
3. meets other requirements that the IRS may prescribe in regulations or other guidance.

An individual cannot be a qualified appraiser with respect to any specific appraisal unless he:

1. demonstrates verifiable education and experience in valuing the property type being appraised; and
2. has not been prohibited from practicing before the IRS at any time over the past three year period ending on the appraisal date.

It is now imperative that the donor check the credentials of the appraiser in order to ensure that the appraiser is an expert in the item being appraised. In other words, an expert appraiser for Dutch 17th century drawing will not be the correct appraiser for a work of contemporary art.

The existing IRC regulations still apply regarding the independence of the appraiser. Under these IRC regulations the term "qualified appraiser" means an individual who holds himself out to the public as an appraiser who is an expert as to the particular type of property being appraised; who understands that if he makes a false or fraudulent overstatement of value, he may be subject to a civil penalty under section 6701; and who is completely independent of the donor. To be independent of the donor, the qualified appraiser cannot be the donor or the donee, a party to the transaction in which the donor acquired the property, a person employed by any of the foregoing, or a person related (within the meaning of section 267(b)) to any of the foregoing.

For example, if a person acquired a painting from an art dealer and later donated the painting to a museum, the donor, the dealer who sold the painting, the

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177 Treas. Reg. § 1.170A-13(c)(5)(i).
museum, any person employed by the donor or the dealer or the museum, or any person related to any of the foregoing is not a qualified appraiser. The regulations are so broad that they appear to disqualify an auction house from being a qualified appraiser if the donor had purchased the property at auction from that auction house.

The final regulations adopted on May 4, 1988, did retain the provision that disqualifies someone who regularly performs appraisals for a person who is not otherwise excluded from being a qualified appraiser and does not do a substantial number of appraisals for other persons—for example, someone who performs appraisals for only one person. Also excluded as a qualified appraiser is any person who, if the donor had knowledge of the facts, would cause a reasonable person to expect that the appraiser would falsely overstate the value of the donated property. For example, the donor and the appraiser make an agreement concerning the amount at which the property will be valued, and the donor knows that the amount exceeds the fair market value of the property.

The appraiser selected must be a qualified appraiser because, if the donor chooses unwisely and the appraiser is later found not to be a qualified appraiser, the entire charitable deduction is lost, since it is then too late to correct the defect. In order to obtain the income tax deduction, the taxpayer must attach to the income tax return a qualified appraisal prepared by a qualified appraiser.

There is a new penalty to be assessed against appraisers for certain types of valuation misstatements under section 6695 A. A person who prepares an appraisal of property must pay a penalty if: (1) he knows or reasonably should have known, that the appraisal would be used in connection with a federal tax return or refund claim; and (2) the claimed value of the appraised property results in a substantial valuation misstatement or a gross valuation misstatement related to income tax. The penalty is the lesser of: (1) the greater of $1,000 or 10 percent of the tax underpayment amount attributable to the misstatement; or (2) 125 percent of the gross income received by the appraiser for preparing the appraisal. However, no penalty is imposed if the appraiser establishes that the appraised value of the property was more likely than not the proper value for the property, section 6695A(c).

1. **Notice 2006-96-New Appraisal Requirements**

Notice 2006-96 issued by the IRS in October 2006, offers some guidance as to the new appraisal rules introduced by the Pension Protection Act of 2006. According to the Notice, an appraisal will be treated as a qualified appraisal under the new rules if the appraisal complies with all the requirements of the existing IRS regulations and is conducted by a qualified appraiser in accordance with generally

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accepted appraisal standards. An appraisal is treated as having been conducted in accordance with generally accepted appraisal standards if, according to the Notice, the appraisal is consistent with the substance and principles of the Uniform Standards of Professional Appraisal Practice ("USPAP"), as developed by the Appraisal Standards Board of the Appraisal Foundation.\textsuperscript{180}

An appraiser will be treated as having demonstrated verifiable education and experience in valuing the type of property subject to the appraisal if the appraiser makes a declaration in the appraisal that, because of the appraiser's background, experience, education and membership in professional association, the appraiser is qualified to make appraisals of the type of property being valued. For appraisals for returns filed after February 16, 2007, the appraiser will be treated as having met the minimum education and experience requirements if the appraiser has (i) successfully complete college or professional-level coursework that is relevant to the property being valued, (ii) obtained at least two years' experience in the trade or business of buying, selling, or valuing the type of property being valued, and (iii) the appraiser gives a full description of his educational background.\textsuperscript{181}

D. FRACTIONAL GIFTS TO CHARITABLE ORGANIZATIONS

1. Fractional Gifts-Prior to August 2006

Prior to August 17, 2006 the collector who wanted to give away a collection and still enjoy its possessions on a part-time basis could convey an undivided fractional interest in the property to a charity. The transfer of an undivided fractional interest was not a transfer of a future interest than ran afoul of section 170(a)(3) or section 170(f).\textsuperscript{182} Therefore, an immediate charitable deduction was allowable for the value of the undivided fractional interest donated. In the case of James I. Winokur,\textsuperscript{183} the court held that it is the right to entitlement or possession, not actual physical possession, that controls whether a purported present interest is to be regarded as a future interest.

For example, Ms. Collector transfers an undivided one-fourth present interest in a painting to an art museum by deed of gift. She is entitled to the possession of the painting for nine months each year, and the museum is entitled to possession for three months each year. Ms. Collector can deduct one-fourth of the fair market value of the painting as a charitable contribution on the date of the gift, subject to the permissible maximum.

\begin{flushleft}
\textsuperscript{180} Id. at § 3.02(2).
\textsuperscript{181} Id. at § 3.03(3)(b).
\end{flushleft}
The IRS position is to accept as the allowable charitable deduction the undivided percentage of the fair market value given to the charitable organization. Presumably, that position is based on Revenue Ruling 57-293,184 which gives a specific example covering that situation. The part of that ruling dealing with a gift of a future interest is no longer applicable because of section 170(f).

2. Fractional Gifts—After August 17, 2006

The Internal Revenue Service was concerned that there was abuse of the fractional gift technique - that is, situations were discovered where a taxpayer claimed a deduction for a fractional interest in a work of art yet retained physical possession of the donated property for the full year. Under new section 170(o) introduced by the PPA, effective for contributions made after August 17, 2006, fractional gifts are no longer desirable.

i. Valuation Limitation.

Under section 170(o), the collector's initial contribution of a fractional interest in a work of art is determined as under current law and described above (full fair market value times the fractional interest donated). For purposes of determining the deductible amount of each additional contribution in the same work of art, the fair market value of the donated item is now limited to the lesser of: (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the fair market value of the item at the time of the subsequent contribution.185 For example, the collector who gives away a 50 percent interest in a painting when it is worth $1,000,000 would still be able to claim a $500,000 deduction. However, when the collector donates the remaining 50 percent interest 10 years later when the painting is work $2,000,000, the collector's donation would be limited to 50 percent of the initial fair market value of $1,000,000, that is $500,000, not 50 percent of the $2,000,000 current value.

ii. Timing Limitation.

The collector must complete the donation of his entire interest in the work of art before the earlier of (1) ten years from the initial fractional contribution or (2) the donor's death.186 If the donee charity is no longer in existence, the collector's remaining interest may be contributed to another section 170(c) organization.

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185 I.R.C. § 170(o)(2).


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51.
iii. Use Limitation.

Under the new provisions, the donee charity of a fractional interest in a work of art must (1) have substantial physical possession of the work of art during the donor allowed possession period (maximum of 10 years) and (2) use the work of art for an exempt use during such period - satisfy the related use rule.\(^{187}\) The Joint Committee on Taxation Report\(^ {188}\) (the JCT Report) gives an example of an art museum described in section 501(c)(3) that is the donee of a fractional interest in a painting which includes the painting in an art exhibit sponsored by the museum, such use generally will be treated as satisfying the related-use requirement. However, the JCT Report contains no example as to the meaning of "substantial physical possession". For example, if a collector donates a 10 percent fractional interest in a painting to a museum and plans on donating the remaining 90 percent 10 years later, does the collector violate the substantial physical possession rule if the museum only has physical possession during the 10 year period for 10 percent of such period? The regulations will need to clarify this provision although, if the museum has physical possession for a period of time equal to the donated percentage interest, that should be sufficient to satisfy this requirement.

iv. Recapture of Deduction.

If the collector violates the 10 year timing limitation or the use limitation (the substantial possession or related-use requirement), then the collector's charitable income and gift tax deductions for all previous contributions of interests in the work of art are recaptured plus interest.\(^ {189}\) In any case in which there is a recapture of a deduction, the statute also imposes an additional tax in an amount equal to 10 percent of the amount recaptured.

v. Denial of Deduction.

No income or gift tax deduction is allowed for a contribution of a fractional interest in a work of art unless immediately before such contribution all interests in the work of art are owned (1) by the collector or (2) by the collector and the donee organization.\(^ {190}\) The IRS is authorized to make exceptions to this rule in cases where all persons who hold an interest in the work of art make proportional contributions of undivided interests in their respective shares of such work of art to the donee organization. For example, if collector A owns an undivided 50 percent interest in a painting and his brother, collector B owns the other undivided 50 percent interest in the

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\(^{188}\) Staff of the Joint Committee on Taxation, "Technical Explanation of H.R.4, The Pension Protection Act of 2006".


\(^{190}\) I.R.C. § 170(o)(1)(A).
same painting, the IRS may under regulations to be issued, provide that A may take a
deduction for a charitable contribution of less than the entire interest held by A, provided
that both A and B make proportional contributions of undivided fractional interests in
their respective shares of the painting to the same donee organization (e.g., if A
contributes 25 percent of A's interest and B contributes 25 percent of B's interest).

**vi. Danger of Fractional Gifts and the Repeal.**

The PPA contained similar limitations as described above for gift and estate tax purposes.\(^{191}\) Like the income tax provision, the estate tax provision limited the
estate tax charitable deduction to the lesser of: (1) the fair market value at the time of the
initial fractional contribution; or (2) the fair market value at the time of the subsequent
contribution.\(^{192}\) In order to avoid the recapture of the income tax deduction, the transfer
to the donee charity must be completed on the earlier often (10) years from the initial
contribution or the donor's death. For example, the collector who gives away a 50 percent
interest in a painting to a museum when it is worth $1,000,000 would receive a $500,000
income tax deduction. If the collector dies four years later when he still owns the
remaining 50 percent interest and if the painting is then worth $2,000,000 his estate tax
charitable deduction is limited to $500,000, that is, 50 percent of the initial value of
$1,000,000 for the 50 percent interest. This would mean that the collector's estate would
have a 50 percent interest in a painting going to a museum with a value of $1,000,000
(for the 50 percent interest) for which the estate was only entitled to a $500,000
deduction resulting in the estate having to pay an estate tax on the remaining $500,000.
This is a trap for the uninformed and was not the result intended by the legislation. On
(P.L. 110-172). The Act repealed the changes made to the estate tax and the gift tax that
resulted in the tax trap described above in this paragraph. The net effect of this change is
as if the special valuation limitation (value at time of initial gift) never existed for estate
and gift tax purposes.

**vii. Future Planning.**

If the valuation limitation described above is corrected, then fractional
gifts may still be useful for a collector who owns a very valuable work of art and
therefore needs to spread the deduction for the initial value over a 12 year period (year of
donation plus 5 year carryover for two transfers). For example, assume a painting with a
fair market value of $5,000,000 owned by an individual with an average yearly adjusted
gross income (AGI) of $1,000,000. Since the maximum allowable charitable deduction is
30 percent of AGI, his maximum deduction if the entire painting was donated is
$1,800,000 ($300,000 x 6, i.e. 30 percent of AGI and a 5 year carryover). If a one-half
fractional interest in the painting is donated, the same $1,800,000 deduction over a six
year period is allowable (50 percent of $5,000,000 is $2,500,000). hi year seven the

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\(^{191}\) I.R.C. § 2055(g); I.R.C. § 2522(e).

\(^{192}\) I.R.C. § 2055(g)(1).

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individual can donate the remaining 50 percent interest in the painting and receive another $1,800,000 deduction spread over the following six years. Since the initial value of the painting is high, the individual would not be concerned with loss of the appreciation in value of the painting as a deduction. However, until there is a change in the tax code this type of fractional gift should not be made.

E. NEW PENALTY RULES

The Revenue Reconciliation Act of 1989 attempted to streamline rather complex provisions and to provide a fairer and more effective penalty system. Currently, section 6662 consolidates the generally applicable penalties relating to the accuracy of tax returns into one accuracy-related penalty equal to 20% of the portion of the underpayment to which the penalty applies. The PPA (effective August 17, 2006) further modified the thresholds for the application of the penalties.

For income tax purposes, there is a "substantial valuation misstatement" if the value of a work of art contributed to charity is 150% or more of the amount determined to be the correct amount of the valuation. The 20% penalty is increased to 40% if the discrepancy is 200% or more, a "gross valuation misstatement." No penalty is imposed for an underpayment of tax resulting from a substantial overvaluation of a charitable deduction for a work of art if it is shown that there was reasonable cause for the underpayment and if the taxpayer acted in good faith with respect to the underpayment. However, that exception does not apply unless (1) the claimed value of the property was based on a qualified appraisal made by a qualified appraiser and (2) the taxpayer also made a good-faith investigation of the value of the contributed property. To satisfy the second requirement, the taxpayer should keep a diary or a memorandum about his personal investigation of the value of the property. That is, there should be careful documentation of the taxpayer's investigation of the property's value. Under section 6662(e)(2), at least $5,000 of additional tax must be due for the penalty to apply.

The reasonable cause exception for underpayments due to "gross valuation misstatements" on charitable deduction property is eliminated effective August 17, 2006. The reasonable cause exception does remain for a "substantial valuation misstatement". 197

193 I.R.C. § 6662(e)(1).
194 I.R.C. § 6662(h)(1).
195 I.R.C. § 6664(c)(1).
196 I.R.C. § 6664(c)(2).
197 I.R.C. § 6664(c)(2).
The willingness of the IRS to impose penalties in appropriate cases is illustrated by the *Jacobson* case, which involved a stamp collector who had a collection of both postage stamps and postal stationery, that is, first-day-of-issue stamps that have passed through the mail. The taxpayer had acquired 60,484 first-day pages, which he owned for approximately twenty-five years. He never had any insurance on the contributive property, and he stored the property in boxes in his bakery warehouse. The court took note of the facts that the warehouse had a rodent problem, was very hot during the summer, and had almost no security. The taxpayer claimed a deduction for the donated stamp property in the amount of $949,030, but the tax court held that the correct value was $12,973. The question was then presented whether the section 6662(h)(2)(A) 40% penalty applies since there was a gross valuation misstatement, that is, the value of the property claimed on the tax return ($949,030) was 400% or more of the amount determined to be the correct value ($12,973). The taxpayer said he relied on his appraisal in claiming the $949,030 deduction and that he therefore acted reasonably even though the court found that the valuation was too high. The court pointed out that there is a two-part requirement to avoid the penalty: There must be reasonable cause for the taxpayer's position and the taxpayer must have acted in "good faith." The good-faith exception applies only if (1) the claimed value of the property was based on a "qualified appraisal" made by a "qualified appraiser" and (2) in addition to obtaining such an appraisal, the taxpayer made a good-faith investigation of the value of the contributed property. The court found that the taxpayer had not acted in good faith, because his conduct with respect to the contributed property was not consistent with a taxpayer's behavior if the property had substantial value: That is, there was no insurance; the property was inappropriately stored in a hot, rodent-infested warehouse; there was no security; and it was not treated like property that had a value of almost $1 million. Accordingly, the court assessed the penalty.

For estate and gift tax purposes, section 6662(g)(1) imposes the 20% penalty if the value of any property claimed on an estate or gift tax return is 50% or less of the amount determined to be correct. If the understatement is attributable to a gross valuation misstatement of 25% or less of the correct amount, the penalty amount is increased to 40% of the underpayment. At least $5,000 of additional tax must be due for the penalty to apply.199

Unlike the income tax law, estate and gift tax laws do not require a qualified appraisal by a qualified appraiser. The IRS has discretionary authority to waive all or part of the section 6662 penalty if the taxpayer establishes that there was a reasonable basis for the valuation claimed and that the claim was made in good faith.

The section 6662(g) penalty appears to apply for estate and gift tax purposes only to valuation understatements, not to overstatements. Therefore, if a

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199 I.R.C. § 6662(g).

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decendent bequeathed artwork to a museum and an estate tax charitable deduction is claimed, no section 6662 penalty is imposed if the IRS determines that the work had a smaller value than that claimed on the estate tax return. In most cases, the estate tax does not increase or decrease in the case of a valuation overstatement of a charitable bequest, since the size of the gross estate increases as the charitable deduction increases; the two cancel each other out, leaving only the remainder subject to the estate tax. Therefore, the section 6662 penalty should generally not apply to an estate charitable bequest that may be overstated in value. However, a valuation overstatement of a work of art could increase the executor's commission (which is deductible on the estate tax return) and have the net effect of decreasing the estate tax.

A section 6662 penalty could be applied in an estate tax situation for income tax purposes. For example, when the unlimited marital deduction applies or when the estate is less than the estate tax exemption equivalent (that is, less than $2,000,000 in year 2006), there is no estate tax. However, any artwork, as well as other tangible property of the estate, receives a step-up in basis equal to the estate tax value. If the artwork that was overvalued for estate tax purposes is later sold at a loss, the estate or the heirs have a capital loss that may be deductible under section 165(c)(2). If the loss claimed to reduce the income tax results from the overvaluation, the IRS can invoke the penalty provisions of section 6662.

F. DONATION OF TAXIDERMY PROPERTY

For taxidermy property that is contributed by the person who prepared, stuffed, or mounted the property or by a person who paid or incurred the cost of preparation, stuffing, or mounting, the amount of the claimed charitable contribution must be reduced by the amount of gain that would have been long-term capital gain if the property had been sold by the taxpayer at its fair market value.200 Fair market value is determined at the time the contribution is made.201 Thus, the amount that will be allowed as a deduction for a charitable contribution of taxidermy property is the lesser of the donor's basis in the property or the fair market value of the property.

If taxidermy property is contributed and a charitable contribution deduction is claimed by the person who prepared, stuffed, or mounted the property, or by any person who paid or incurred the cost of such preparation, stuffing, or mounting, only the cost of preparing, stuffing, or mounting the taxidermy property may be included in the calculating the basis of the property.202

This special rule for determining the donor's basis in taxidermy property is intended to include only the direct costs of preparing, stuffing or mounting that are paid

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or incurred by the donor claiming the charitable contribution deduction. Indirect costs, such as transportation, equipment or other costs related to hunting or killing the animal may not be included in the donor's basis, and are, therefore, not deductible.203

Reducing the abuse of the lenient deduction rules for such charitable contributions was a primary motivation for amending the rules. According to the Humane Society of the United States, the charitable contribution deduction rules for taxidermy property were being exploited by trophy hunters; the rules allowed them to unfairly deduct the costs of their hunting excursions. The modified rules do not allow the donor to claim a deduction for such expenses and consequently, also eliminate the deduction for value based on the rarity of the animal.

The term "taxidermy property"204 means any work of art which—

(1) is the reproduction or preservation of an animal, in whole or in part,

(2) is prepared, stuffed, or mounted for purposes of recreating one or more characteristics of such animal; and

(3) contains a part of the body of the dead animal.

III. FRACTIONAL TRANSFERS-VALUATION ISSUES

A. BACKGROUND

When fractional donations were made to charity prior to August 17, 2006, the position of the IRS was to accept as the allowable charitable deduction the undivided percentage of the fair market value given to the charitable organization. Presumably, that position is based on Revenue Ruling 57-293,205 which gives a specific example covering that situation. The part of that ruling dealing with a gift of a future interest is no longer applicable because of section 170(f).

When the collector dies, the value of the undivided fractional interest that was kept by the collector is included in his estate. Because of Revenue Ruling 57-293, it is difficult to argue that if the retained undivided interest is bequeathed to a noncharitable beneficiary, there should be a discount for the minority undivided interest retained. In Estate of Robert C. Scull v. Commissioner,206 the value of the decedent's 65% undivided interest in an art collection was reduced by 5% to reflect the uncertainties involved in any

203 Supra, note 187.


acquisition of the interest, which was the result of a divorce proceeding still being appealed. If the bequest is made to a person who does not own the other part of the interest, the taxpayer should have a fair chance of convincing the IRS to allow some discount for the fractional interest. If the bequest is made to a museum that already owns a partial interest in the artwork, the estate tax charitable deduction should be the percentage owned by the decedent multiplied by the full fair market value of the painting on the decedent's date of death. Generally, before a museum will accept a fractional gift, it wants assurances that it will receive the balance of the undivided interest when the collector dies. The museum does not want to be left owning a fractional interest in a work of art with the donor's heirs fighting over the remaining fractional interest. Therefore, the collector should always discuss such a gift with the museum before making it.

Although, as discussed above, fractional donations to charity no longer make sense, the following Private Letter Rulings are instructive for complete transfers of works of art to charity. Private Letter Ruling 93-03-007 should be reviewed by anyone contemplating a donation of works of art. The IRS ruled that the charitable deduction for the gift of an undivided fractional interest equals the product of (1) the fraction and (2) the fair market value (determined without regard to the existence of a certain loan agreement) of the entire work of art at the date of the gift of the fractional interest. Under a gift-loan agreement, the taxpayer in that private letter ruling imposed conditions requiring continuous display of the collection and editorial control over publicity concerning the collection. If those conditions were not complied with, the collection would revert to the donor or his heirs. The IRS ruled that such conditions had no effect on the gift, since the chance that the work would revert to the estate of the donor is so remote as to be negligible.

When a fractional interest in a collection is donated to a charitable organization, the organization usually requires the donor to promise to donate or bequeath the balance to the organization. Private Letter Ruling 93-03-007 also states that when one promises to transfer property in the future, the gift tax consequences of the promise are judged as of the time at which it is possible to determine that the transfer must be made and that the transfer will be of a determinable amount. Therefore, the mere execution of a promised-gift agreement does not constitute a taxable gift, because at that time it is not possible to determine that the future transfer must be made by the donor. The promised gift could be satisfied by the donor's estate.

Private Letter Ruling 200223013 dealt with fourteen separate rulings pertaining to the federal income, gift, and estate tax consequences of gifts of fractional interest in works of art to be made by a married couple to a tax-exempt museum. The proposed gift was subject to a detailed and comprehensive gift and loan agreement (GLA) that contained a number of restrictions and limitations. So long as the museum complied with the GLA, the donors were not permitted to transfer during their lifetimes (or at the death of the first of them to die) by gift or otherwise any item of artwork to any

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party other than to each other or the museum. If the museum complied with the GLA, then the donors (or their legal representative) were obligated at a date no later than the death of the last to die of the donors to transfer to the museum all of the donors' remaining ownership interests in the artworks. If the museum breached the GLA, the artwork was to be distributed to other charitable organizations. Under the GLA, the museum was required to hold and display the artwork subject to numerous conditions, including that the museum was required to obtain the donors' consent to any changes in the gallery or installation design. In addition, the museum was permitted to deaccession any artwork, but only to the extent such work was replaced with a similar item of artwork typified by the collection,

(1) that is consistent with the spirit of the collection, and

(2) that has a value substantially equal to the value of the deaccessioned artwork in the collection.

Upon the death of the donors, these approval rights transferred to their daughter.

For income tax purposes, the IRS held, following the formula in Private Letter Ruling 93-03-007, that the amount of the income tax deduction allowable for a fractional interest is equal to the percentage of the artwork donated multiplied by the fair market value of the entire artwork. No reduction in the amount of the income tax deduction is required because only a fractional interest was donated or because of the restrictions placed on the donee with regard to the artwork as described above.

For estate tax purposes, the IRS ruled that the approval rights retained by the donor that pass to her successors in interest have no value for federal estate tax purposes under sections 2031 and 2033. The IRS also ruled that because the artwork will pass to other charitable organizations if the museum breaches the GLA, there is no possibility that the items will pass for other than a charitable purpose as defined in section 2055(a) and, hence, the value of the bequest will qualify for the federal estate tax charitable deduction under section 2055. Moreover, the IRS determined that the amount includable in the donor's gross estate under sections 2031 and 2033 with respect to the retained undivided fractional interest is the fair market value of the item of artwork multiplied by the donor's fractional interest therein and that the amount deductible under section 2055 with respect to such item is the value included in the donor's gross estate.

Finally, the IRS ruled with respect to the federal estate tax that when the donor died the bequest to the donor's spouse of any retained fractional interest in the artwork will qualify for the federal estate tax marital deduction permitted under section 2056(b)(7) (assuming the required election is made). The ruling went on to confirm that the amount of the marital deduction is the fair market value of the artwork (determined without regard to the existence of the GLA) multiplied by the fraction of the artwork transferred to the surviving spouse. This avoids any potential problem that the estate
inclusion amount under section 2031 may not be the same amount as either the charitable deduction under section 2044 or the marital deduction under section 2056.

When considering whether or not to make a fractional gift to a museum, the donor should also be aware of the following questions that should be answered before making the donation.

1. Who will pay for packing and transportation each time the collection is moved?

2. Who will pay for insurance? Generally, the donor's insurance covers the collection when it is in the donor's possession, and the museum's insurance covers the collection when it is in the museum's possession. Insurance coverage during the packing and shipping period should be discussed.

3. In the future operation of the museum, what will be done with the collection, how will it be exhibited, and will the museum consult with the donor?

4. Does the museum have an endowment; if so, how are funds allocated to its operation? As the museum expands in size, its expenses will increase. Will there be a special curator for the collection, and how will the curator be selected and paid?

5. What, if any, involvement will the donor have with respect to the exhibition of the collection at the museum?

6. What will happen if the artwork is damaged? Every time art is moved, there is always the risk of some damage. There should be some procedure involving condition reports, and perhaps some works of art should not be moved every year. For example, some Calder mobiles are susceptible to damage every time they are packed and rehung.

B. THE STONE CASE

In August 2007, the case of Robert G. Stone v. United States, allowed a 5% discount to an estate that owned an undivided 50% interest in nineteen paintings that were left to family members. The Stone case is the first case to reflect on whether or not discounts based on lack of control, minority ownership, or lack of 100% interest with respect to ownership of works of art can lead to a discount for estate tax purposes as it

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does for real estate. In *Stone* the estate claimed a 44% discount for the undivided 50% interest in the painting owned by the decedent on the date of death. The IRS said that "art is simply not fungible" and the discount should be not more than 2%. The court concluded that a hypothetical willing seller of an undivided fractional interest in art would likely seek to sell the entire work of art and split the proceeds, rather than seeking to sell his or her fractional interest at a discount. In other words, the court thought that a hypothetical willing seller who is under no compulsion to sell would seek to gain consent from the other co-owner or co-owners to sell the collection and divide the proceeds or, barring such consent, would bring a legal action to partition. Therefore, at a minimum, because an undivided interest holder has the right to partition, a hypothetical seller under no compulsion to sell would not accept any less for his or her undivided interest than could be obtained by splitting proceeds in this manner. Rather than reach a conclusion, the court remanded the case to see if the IRS and the taxpayer could agree on an appropriate discount, between the 2% position of the IRS and the 51% position of the taxpayer, based on the cost of a hypothetical partition action. When the parties were unable to agree, the court was forced to make a decision.

The court in *Stone* then decided that the taxpayer's appraisal methodology was flawed because (i) it failed to take into account that collectors of art are often drawn to the aesthetics of a particular work of art, rather than viewing art simply as an investment vehicle and (ii) the mathematical assumptions made by the appraiser as to the rate of return on investments in art and the appropriate net present value percentage was made without supporting evidence. The taxpayer could not meet his burden of persuading the court that a hypothetical buyer would demand, and a hypothetical seller would agree to, a discount greater than 5%. The case is a warning sign that art is treated differently from real estate or closely held businesses when it comes time to apply discounts. Accordingly, it should not be assumed that the discounts usually available for lack of 100% ownership interest will be available in the same manner as real estate.

A review of the IRS interpretation of fractional gifts beginning with Revenue Ruling 57-293 and then Private Letter Rulings 93-03-007, 200223013, and 200418002 shows that the IRS has been consistent in its interpretation for income tax, gift tax, and estate tax that the proper approach for determining the amount of the deduction, whether the work of art is donated during lifetime or is transferred at death, is to take the full fair market value of the work of art multiplied by the percentage transferred. The position of the IRS is that the same methodology is true whether the work of art is transferred to charity or to a noncharitable beneficiary, that is, a member of the taxpayer's family. In other words, fractional interests in works of art seem to receive a different treatment than fractional interest in real estate or other assets for which it is

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fairly common to claim a discount for lack of control, minority ownership, or lack of 100% interest.\textsuperscript{210}

The Ninth Circuit Court of Appeals affirmed the District Court opinion on March 24, 2009.\textsuperscript{211} In affirming the District Court opinion, the Ninth Circuit pointed out that the regulations require valuation based on a hypothetical willing buyer and a hypothetical willing seller but it is the taxpayer who bears the burden of proof. The Ninth Circuit found that the taxpayer’s expert lacked experience with the art market and that there are dissimilar motives driving purchasers to acquire art and those acquiring real estate or limited-partnership shares. Although there was very little market data on the sale of fractional interests in works of art, the IRS regulations require the assumption of a hypothetical market. In the assumed hypothetical market for the sale of the fractional interest, the District Court did not “clearly err” in adopting the IRS position of a 5% discount.

Perhaps works of art are treated differently because one can still fully enjoy a work of art for a percentage of the time and, in fact, that percentage may have a market value equal to the percentage multiplied by the fair market value of the work of art. With no market data available for the sale of an undivided fractional interest in art, it could just as easily be assumed as not, that a hypothetical willing buyer would be willing to pay a percentage times the full fair market value of a painting equal to his percentage of ownership, in order to own and have personal use of the painting, even if it is only for a percentage of each year. Such is the passion of art collectors. If a transfer is made to a person who does not own the other part of the interest, the taxpayer should have a fair chance of convincing the IRS to allow some small discount for a fractional interest in the painting. If the transfer is made to a person (a museum) that already owns a partial interest in the painting, the charitable deduction should be the percentage transferred multiplied by the full fair market value of the painting on the date of transfer. However, in light of the foregoing rulings and the decision in the Stone case, if one is thinking of transferring works of art to family members either during one's lifetime or on death, it

\textsuperscript{210} Given the basic premises of valuation (the price a hypothetical willing buyer will pay to a hypothetical willing seller), the question arises whether there is a particular reason why a fractional interest in an item of property would make the property less appealing to the hypothetical willing buyer. Neither the Internal Revenue Code, nor the regulations (except for the reference in Treas. Reg. \textsection 20.2031-1) contain any specific provisions on the issue of valuing fractional interests. See Hood, Jr., 830-2nd BNA T.M. Portfolio, \textit{Valuation: General and Real Estate}, Section II.H.4; The IRS usually takes the position that, in the absence of evidence to the contrary, the fact that the interest involved is a fractional interest does not warrant any discount, that is, the value of such interest is equivalent to the proportionate part of the value of the entire interest. However, when it comes to a fractional interest in real estate, some discount is generally allowed. Iacono v. Comm'r, 41 T.C.M. (CCH) 407 (1980); In re Gilberts Est., 163 N.Y.S. 974 (1917); Stevens Est. v. Comm'r, 79 T.C.M. (CCH) 1519 (2000); Forbes Est. v. Comm'r, 81 T.C.M. (CCH) 1399 (2000); Baird Est. v. Comm'r, 82 T.C.M. (CCH) 666 (2001); TAM 199943003 where the National Office advised that, if a discount is appropriate, one method of determining the fair market value of a decedent's undivided interests in tracts of real property is to subtract the partition sale costs from the fair market value of the undivided interests.

\textsuperscript{211} Supra, note 207.
should not be assumed that the discounts usually available for lack of a 100% ownership interest will be available.\textsuperscript{212}

IV. BASIS FOR PURPOSES OF SALE

One of the most important tax consequences of death is that property included in a decedent's gross estate for federal estate tax purposes acquires a "step-up" in basis for income tax purposes equal to its federal estate tax value.\textsuperscript{213} Section 1014 provides that the basis of property acquired from a decedent is the fair market value of the property at the date of the decedent's death or the alternate valuation date. In other words, if a collector purchased a painting for $10,000 and when he dies the painting is valued at $100,000 for federal estate tax purposes, his heirs will acquire the painting with a "step-up" in basis equal to $100,000. The fair market value of the property as of the date of the decedent's death or as of the alternate valuation date is deemed to be the value of the property "as appraised for purposes of the federal estate tax."

A. THE JANIS CASE

The Janis\textsuperscript{214} case is an example of a taxpayer who wanted to have his cake and eat it too! Here the decedent, the well-known New York City art dealer Sidney Janis, died owning many works of art in the gallery that he ran as a sole proprietorship. The IRS Art Panel first determined the total value of the works of art owned at death to be $36,000,000 based on a per item appraisal submitted by the executors. The panel then allowed a $13,600,000 discount based on the following arguments made by the taxpayer:

(1) there were numerous works by individual artists;

(2) some of the art would be sold in the dealer market as opposed to the retail market;

(3) the executor's inability to sell the gallery in the retail market for the sum of the value of the individual works of art;

(4) the fact that a buyer of the gallery would not pay the full resale price of the underlying assets in a bulk sale; and

(5) any buyer would consider the cost of maintaining the business for a reasonable period of time.

After accepting the taxpayer's arguments that reduced the value of the artworks by $13,600,000 the IRS Art Panel agreed to further apply a blockage discount.

\textsuperscript{212} Supra, note 205; note 207.

\textsuperscript{213} I.R.C. § 1014.

\textsuperscript{214} Janis v. Commissioner, 87 T.C. Memo 1322 (2004).
The panel first acknowledged that the blockage concept generally applies to a large number of works by one artist, usually in an artist's estate. It then went on to apply some of the general blockage discount principles to the gallery's inventory as follows:

A number of factors have been considered in determining whether a blockage discount is appropriate and to what extent it should be applied to the subject properties. Consideration was given to the prominence of the artists; the types of works in the estate; the distribution of the items (for example, the number and types, and their quality and saleability); the number of similar items available in the marketplace; the market's response to such works around the valuation date; the number of sales and the prices at which sales were made during the period immediately preceding and following death; the annual sales of the gallery; length of time necessary to dispose of the items; the works that are saleable within a relatively short period of time; the works that can only be marketed over a long period; the demonstrated earning capacity of the business; the tangible and intangible assets, including goodwill; and the reputation of the gallery and provenance.

In addition, consideration was given to the possible disbursement and handling of the gallery. One option would be the continuation of the gallery through Sidney Janis' surviving sons and the selling of the items in the course of business. Another option would be the sale of the gallery to a willing purchaser.

Attention was given to the gallery's annual gross and net receipts of the inventory since 1985.

This resulted in a further 37% reduction of the value of the gallery's inventory or a total combined discount of approximately 60.42%. This was a great success for the taxpayer—but it was not enough.

When the heirs of the estate sold some of the artworks, they used as their new stepped-up basis the original per item appraised value accepted by the IRS Art Panel before the application of the 60.42% discount. The heirs argued that the term "appraised value" in regulation section 1.1014-3(a) refers to the undiscounted fair market value since the discount determined by the IRS Art Panel was attributable to the collection as a whole and does not apply in determining the value of each work of art sold separately. In addition, the heirs argued that *Augustus v. Commissioner*, 215 a 1939 case dealing with the sale of stock, supported the use of the undiscounted value for income tax purposes. The Tax Court distinguished the *Augustus* case and found that because the substantive effect of the blockage discount was to establish a proportionate value for each work of art in the collection, it follows that the "appraised value" contemplated by section 1.1014-3(a) is a

215 Augustus v. Commissioner, 40 B.T.A. 1201 (1939), aff'd, 118 F.2d 38 (6th Cir. 1941).
value that includes the blockage discount. Accordingly, the taxpayer's step-up in basis was limited to the discounted per artwork value.

The heirs of the estate appealed the Tax Court's decision to the Ninth Circuit\(^ {216} \) which affirmed the Tax Court's decision, holding that the Tax Court did not clearly err in determining the value of the art collection and was correct in concluding that the "duty of consistency" required the parties to use the same value on the income tax returns as agreed to for estate tax purposes. The duty of consistency applies when there is (1) a representation by the taxpayer, (2) on which the IRS relies, and (3) after the statute of limitations runs, the taxpayer changes his previous representation. The Ninth Circuit determined that the heirs had represented that the art collection had a value for estate tax purposes, the IRS had agreed to that value and to allow the heirs to now take the position that the art collection had a different value would "gut the duty of consistency."

ENDNOTES